STANDARD & POOR'S

Islamic Finance Outlook 2008



STANDARD & POOR'S

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FOREWORD

Islamic finance continued to grow at an impressive rate in 2007, reaffirming its position as one of international finance's most dynamic sectors. While this growth represents a major achievement, it has also created new challenges for investors, regulators, customers, and also Islamic financial institutions themselves. Standard & Poor's Ratings Services is more than ever committed to accompanying this growth based on its longstanding expertise in the field. The year 2007 brought major achievements, with the launch of several new products specifically designed to cater to the needs of the Islamic finance community. In September we launched our stability ratings for Islamic banks offering profit-sharing investment accounts (PSIAs) as an additional means of conveying, in a powerful and effective manner, key information about these unique financial instruments to depositors, investors, and partners. We have also launched several new equity indices that track the stocks of Sharia-compliant companies worldwide. Finally, Standard & Poor's was voted "Best Islamic Rating Agency" by Islamic Finance News, one of the industry's leading publications.

We believe that the outlook for Islamic finance in 2008 remains bright. Mounting demand around the world for Sharia-compliant financial products and services is fuelling the Islamic banking industry's buoyant expansion. More and more customers are choosing to invest in a broader range of Islamic financial instruments available in the Gulf Cooperation Council states and Muslim Asia, while increasing interest in Muslim and non-Muslim countries alike is contributing to the development of Islamic finance beyond historical boundaries. However, some new challenges are emerging and a uniform, coherent, and harmonized Sharia-compliant financial code has yet to emerge. It is therefore important that the Islamic finance industry does not become complacent; Islamic financial institutions still face a long journey ahead in building stronger recognition, longer track records, and greater scale.

We are very pleased to release our updated Islamic finance brochure. It includes topical research articles on Islamic finance and rating methodologies specific to this area, as well as selected summary analyses of sukuk that we rate. More detailed analyses are available on RatingsDirect, Standard & Poor's Web-based credit analysis system. In the context of the growing need for transparent and full disclosure, we believe that we can make a significant contribution to reaching this objective. Through our knowledge of the specifics of this sector and its key players we are committed to providing objective and accurate insight into the Islamic finance industry, which we hope will benefit all market constituents.

Paul Coughlin

Executive Managing Director
Corporate & Government Ratings
Standard & Poor's

Islamic Issues & Issuers Rated By Standard & Poor's Jan. 15, 2008

ISSUE CREDIT RATINGS

	Originator	Date of rating	Issue amount (mil. $)	Long-term foreign currency rating
1	Central Bank of Bahrain Sukuk	Various	1,094	A
2	DIB Sukuk Co. Ltd.	Feb. 15, 2007	750	A
3	DP Wolrd Sukuk Ltd. (Obligor: DP World)	June 27, 2007	1,500	A+
4	Dubai Sukuk Center Ltd (Guarantor: DIFC Investment LLC)	May 25, 2007	1,250	A+
5	East Cameron Gas Co. Sukuk	July 31, 2006	166	CCC+
6	EIB Sukuk Company Ltd. Programme (Guarantor: Emirates Bank International)	May 15, 2007	1,000	A
7	GFH Sukuk Ltd. (Obligor: Gulf Finance House)	June 26, 2007	1,000	BBB-
8	Gold Sukuk dmcc (Guarantor: Dubai Multi Commodities Centre Authority)	April 11, 2005	200	A
9	Golden Belt 1 B.S.C.	April 18, 2007	650	BBB+
10	Islamic Development Bank	May 20, 2005	1,000	AAA
11	Ithmaar Sukuk Ltd. (Guarantor: Shamil Bank of Bahrain)	June 20, 2007	TBD	BBB-
12	JAFZ Sukuk Ltd	Nov. 8, 2007	AED 7,500	A+
13	Loehmann's Capital Corp. (Guarantor: Loehmann's Holdings Inc.)	Sept 22, 2004	110	CCC+
14	Malaysia Global Sukuk Inc.	June 10, 2002	600	A-
15	MBB Sukuk Inc.	April 11, 2007	300	BBB+
16	Pakistan International Sukuk Co.	Dec. 23, 2004	600	B+
17	Qatar Global Sukuk QSC	Sept. 10, 2003	700	AA-
18	Sarawak Corporate Sukuk Inc.	Nov. 30, 2004	350	A-
19	Sharjah Islamic Bank Sukuk	Sept. 12, 2006	255	BBB
20	Solidarity Trust Services Ltd. (Guarantor: Islamic Development Bank)	Aug. 11, 2003	400	AAA
21	Stichting Sachsen-Anhalt Trust	July 9, 2004	130	AA-
22	Tabreed 06 Financing Corp.	June 15, 2006	200	BBB-
		TOTAL	**14,297**	

ISSUER CREDIT RATINGS

	Issuer	Date of rating	Country	Long-term foreign currency rating
1	Albaraka Banking Group (B.S.C.)	Mar. 21, 2007	Bahrain	BBB-
2	Al Rajhi Bank	Oct. 5, 2005	Saudi Arabia	A
3	Arcapita Bank B.S.C.	Nov. 16, 2006	Bahrain	BBB
4	B.E.S.T. Reinsurance Co.	Sept. 2, 1997	Tunisia	BBB
5	Dubai Islamic Bank	Oct. 18, 2006	United Arab Emirates	A
6	Gulf Finance House	Aug. 7, 2006	Bahrain	BBB-
7	Islamic Development Bank	Dec. 19, 2002	Saudi Arabia	AAA
8	Kuwait Finance House	Aug. 24, 2004	Kuwait	A-
9	Salama/Islamic Arab Insurance Co. (P.S.C.)	May 24, 2007	United Arab Emirates	BBB+
10	Shamil Bank of Bahrain	Nov. 6, 2006	Bahrain	BBB-
11	Sharjah Islamic Bank	Sept. 6, 2006	United Arab Emirates	BBB
12	Takaful Re Ltd.	Oct. 31, 2006	United Arab Emirates	BBB

TBD: to be determined. *AED: United Arab Emirates Dirham.*

Chief Drivers Behind Islamic Finance's Global Expansion

Mounting demand around the world for Sharia-compliant financial products and services is fueling the Islamic banking industry's buoyant expansion. More and more banking clients are choosing to invest in an ever-broader range of Islamic financial instruments available through long-established Islamic banks in the Gulf Cooperation Council (GCC) states and Muslim Asia, while increasing interest in Muslim and non-Muslim countries alike is contributing to the development of Islamic finance outside historical boundaries.

The growing preference for Islamic financial instruments is all the more meaningful with the spread of Islamic banking into new markets. Banking customers in the Arab world and a large part of Asia, as well as Muslims in the West, are increasingly attracted by the Islamic model. The Maghreb is also gradually discovering Sharia-compliant finance. To gain a foothold in this market, conventional banks in Muslim countries, along with global banking majors, are creating Islamic windows, while in the U.K. the Financial Services Authority (FSA) recently licensed the country's first full-fledged Islamic bank.

In markets where Islamic finance is not yet widespread, like North Africa for example, banks may face difficulties to satisfy demand for Sharia-compliant financial products. As late entrants, Islamic banks face the risk of gaining clients with weak credit standings and that have not been part of conventional banking networks.

In the Gulf and Muslim Asia, where Islamic finance has been far more entrenched, Standard & Poor's Ratings Services estimates that 20% of banking customers would now spontaneously choose an Islamic financial product over a conventional one with a similar risk-return profile.

Sharia-compliant assets worldwide total close to an estimated $500 billion and have been growing at more than 10% per year over the past 10 years, placing Islamic finance in a global asset class all its own. In comparison, Islamic assets stood at about $150 billion in the mid-1990s. Islamic banks' market shares are currently 12% in Malaysia and 17% in the six GCC countries. Retail banking services and issuance of Islamic notes, or sukuk, have been and will continue to be frontrunners in the global Islamic finance boom.

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Thirty Years Of Modern Islamic Finance Provide A Solid Platform For Expansion

Islamic finance began as a participative system, compatible with maximizing banks' profits and value and mirroring the aims of conventional banks for over four centuries. Also integral under Islamic law, however, are ethical and religious considerations regarding the sharing of risk and returns.

Modern Islamic finance emerged in the mid-1970s with the founding of the first large Islamic banks, namely Islamic Development Bank (AAA/Stable/A-1+), Dubai Islamic Bank (A/Stable/A-1), and Albaraka Banking Group (B.S.C.) (ABG; BBB-/Stable/A-3) (see table below for Islamic banks rated by Standard & Poor's). For many years, these banks relied on the gradual building of demand through the development and marketing of Sharia-compliant financial instruments. For instance, profits generated by some of the Islamic subsidiaries of ABG--the financial arm of the Dallah Albaraka group--were far lower than for conventional banks operating in the same countries. ABG's majority shareholder and a major pillar of modern Islamic finance,

Sheikh Saleh Al Kamel, nevertheless firmly stood by the bank's strategy.

Signaling a departure from the slow growth of Islamic finance through a steady flow of attractive offerings over two decades, demand for Sharia-compliant investments and loans began to take off in the early 1990s. This fresh interest was sparked by a new geopolitical backdrop in the Gulf and abundant liquidity flows from the recycling of oil dollars in the region's economies. Today, demand rather than supply is driving the development of Islamic products and services, fulfilling the predictions of the pioneers of modern Islamic finance, who had long been convinced of the existence of untapped demand.

Islamic Banking Services Are Unfolding Outside Historical Boundaries

Support provided by the governments of the Gulf countries and certain Muslim states such as Malaysia--where track records in Islamic finance are long--has fostered favorable views of Islamic finance by regulators and supervisory agencies across the Muslim world. Regions with predominantly Muslim populations that were previously reluctant to open their borders to Islamic banks, particularly North Africa, are now also showing interest in Islamic finance.

In February 2007, Tunisia took a large step forward in the realm of Islamic finance, passing legislation permitting the creation of the country's first Islamic bank for the development of trade between Arab countries.

In March 2007, Morocco's central bank, Bank Al-Maghrib, authorized Moroccan banks to offer Islamic banking services for the first time in the country's history. In 2006, following the example of a large number of its peers in the Muslim world, the Central Bank of Morocco (Bank Al-Maghrib) became a shareholder of the International Financial Services Board (IFSB). Based in Malaysia, this "club" of central banks serves as a transnational regulatory body aiming to harmonize standards of prudential regulation applicable to Islamic banks. (For an in-depth look at Islamic finance's development in Morocco and Tunisia, see " Islamic Finance To Expand Slowly But Surely In The Maghreb," published April 23, 2007, on RatingsDirect).

Outside the Muslim world, the global Islamic financial industry stands to benefit from the U.K.'s development as an attractive marketplace for Sharia-compliant financing and investment instruments. We estimate that up to 300,000 retail customers in the U.K. would be ready customers for Sharia-compliant banking services. The establishment of these services in the U.K. would extend the reach of the Islamic financial model outside the Muslim world.

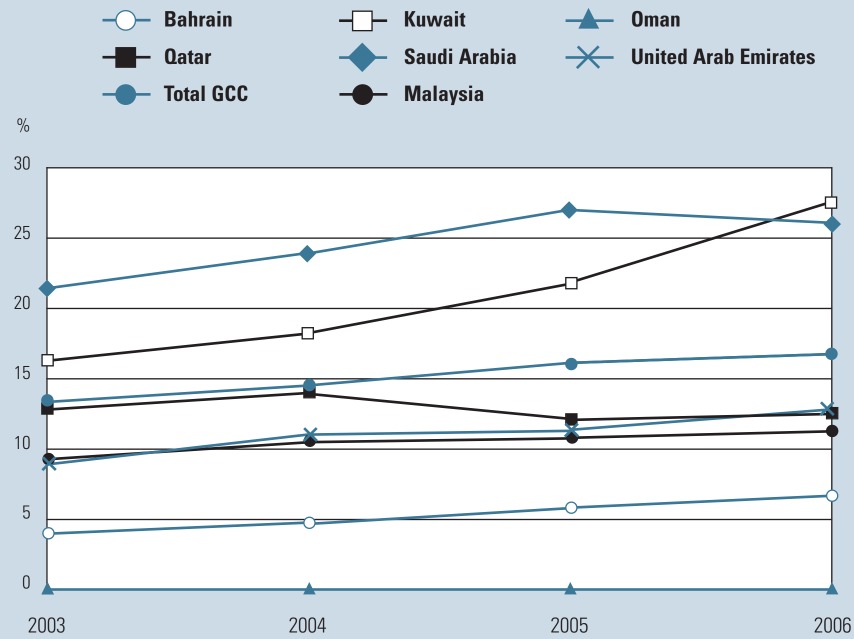
Islamic Retail Banking Is A Growth Ticket

Since the 1990s, Islamic banks in the Gulf and Muslim Asia have focused more systematically on the retail segment, as individual customers are more sensitive to religious arguments than corporate clients. The general uptrend in market share of Islamic banks, since 2003, in the six GCC countries and Malaysia denotes the increase in Islamic banks' assets, which is outpacing already spectacular asset growth at conventional banks (see chart below).

Seeking to attract clients from Europe's Muslim population, Islamic banks are now starting to enter non-Muslim countries, focusing first on the retail segment. This development follows moves into Islamic finance by more and more conventional banks in the Gulf and Malaysia during the last decade, either through Islamic windows or by opening Sharia-compliant subsidiaries. Furthermore, a portion of Europe's Muslims does not use conventional banking facilities because interest or "riba," the cornerstone of conventional finance, is strictly forbidden under some schools of Islamic thought.

In August 2004, the U.K. regulator, the FSA, approved a banking license for the country's first Islamic bank, the Islamic Bank of Britain (IBB) to serve the retail market with Sharia-compliant products and foster the financial integration of Muslim customers of Islamic banks.

ISLAMIC BANKS' MARKET SHARES IN THE GCC COUNTRIES AND MALAYSIA



GCC--Gulf Cooperation Council.

Islamic Wholesale And Investment Banking Are Gaining Ground

European banks are setting their sights on an increasingly broad activity base in Islamic finance, establishing operations in wholesale banking by recycling funds flowing out of the Gulf into Sharia-compliant asset classes in Europe. Illustrating this trend is the mission of London-based European Islamic Investment Bank (EIIB): recycling of institutional and private liquidity in the Gulf into Sharia-compliant asset classes with high returns. These classes comprise assets in the real estate, industrial, infrastructure, and tourism sectors, in mature, efficient, transparent, and diversified Western economies.

Sharia-compliant investment banks are also emerging, mainly in the GCC countries. These banks have no retail customers and refinance themselves chiefly through the interbank market or by issuing sukuk. Investment banks such as Arcapita Bank B.S.C. (BBB/Stable/A-2), Gulf Finance House (BBB-/Stable/A-3), and Unicorn Investment Bank (not rated) are enjoying lofty returns on relatively risky activities that have long been reserved for conventional players. Capital investment, infrastructure project intermediation, and direct real estate investment (usually through leveraged buyouts) have become part of Islamic finance in the past 10 years. Islamic investment banks, carrying inherently higher risk than retail banking units, purchase majority stakes in growth companies that are often not listed and attempt to extract higher returns through their capacity to unlock value at the level of the investee company over the medium term, as well as through systematic recourse to debt, while remaining Sharia-compliant.

Already Popular Sukuks Are Set To Attain Greater Heights

Global sukuk issuance, currently estimated at $70 billion, is set to top the symbolic $100 billion mark by the end of the decade (see table below for sukuk issues rated by Standard & Poor's). Sukuks are a now a mainstay in asset allocation in Malaysia and the GCC countries. The non-Muslim world is also honing in on sukuks, with issuers aiming to tap into surplus liquidity flowing from the Gulf region. Sovereigns such as the U.K. and Japan are exploring the possibility of issuing sukuk. Other issuers, such as the German State of Saxony - Anhalt have

already sprung into action, issuing a 100 million five-year sukuk that we rated 'AA-' in July 2004.

Hand in hand with widening interest in sukuks and Islamic securities in general, London has recently joined the list of major financial hubs to handle Islamic transactions, becoming the sole non-Muslim competitor of natural Islamic markets in Dubai, Kuala Lumpur, and Bahrain. As is the case in wholesale banking, London has the capacity to become a serious contender for Sharia-compliant financial flows that seek recycling in Europe, while competition heats up among the world's financial centers to attract Islamic issuers and investors (see our March 21, 2007, report " World's Islamic Finance Industry To Get A Boost From U.K.'s Development As A Major Marketplace," available on RatingsDirect).

New Islamic Products Are On The Horizon

Newly created Sharia-compliant instruments are set to rival product offerings at conventional banks, in response to increasingly complex demand. On the deposit side, profit-sharing investment accounts (PSIAs) offer depositors the right to share in Islamic banks' profits (and losses), which appear an attractive alternative for customers compared to fixed-rate conventional deposits, at a time when Islamic banks are more profitable than ever (for more details on how PSIAs work in theory and practice, see " Standard & Poor's Looks At Features Of Islamic Banks' Unique Funding Instruments" published on June 15, 2005, on RatingsDirect). As far as asset management is concerned, Islamic financial institutions (IFIs) have been replicating in a Sharia-compliant manner a number of money market, equity, real estate, private equity, and infrastructure funds with comparable risk-return characteristics. Offering them as Sharia-compliant instruments is definitely a plus at a time when liquidity, particularly in the Gulf region, is ample and chasing too few asset classes.

Product diversification at large IFIs remains narrow, however. In most credit portfolio allocations, "ijara" (lease financing) and "murabaha" (the financing of a sale at a predetermined markup) dominate, accompanied to a lesser degree by "istisna" (the financing of equipment or working capital needs), exclusively for corporate borrowers, and more especially larger ones.

The limited product diversification at IFIs comes as no surprise since Islamic finance and the banking needs of individuals are so closely interwoven. Islamic banks continue to target households above all, preferring them to companies that scrutinize more closely the price and quality of a financial transaction. In light of the profits generated in the highly lucrative retail segment, both in the Gulf and in Muslim Asia, incentives to develop particularly risky financial offerings with hefty appetites for capital--either through partnerships such as "mudaraba" (trust financing; a form of partnership where one side provides only capital and the other only labor or entrepreneurial skills) or "musharaka" (a partnership contract where both parties provide capital to finance a project or venture)--remain relatively minimal.

Our Rating Analysis Factors In Specific Characteristics of Islamic Financial Institutions And Products

Standard & Poor's has built strong expertise in assessing the creditworthiness of Sharia-compliant issuers and debt issues over the past decade. We apply the same criteria and ratings methodology to Islamic and non-Islamic financial institutions, as their structures are similar. In addition, we have developed analytical approaches that take into account the unique characteristics of Islamic banks. To factor in these features, we look carefully at assets, refinancing profiles, liquidity management, and credit quality. Islamic banks can differ considerably from conventional banks in these domains.

We do not formulate opinions on the Sharia compliance of any IFI or debt issue (financial transaction or institution). It is the responsibility of the Sharia board of the originating institution to rule on compliance with Islamic law.

Standard & Poor's Approach To Rating Sukuk

Executive Summary

An unprecedented surge in sukuk issuance during the past three years has provided different categories of issuers--sovereigns, corporations, and banks--with an alternative way to structure their funding. Standard & Poor's Ratings Services estimates sukuk outstanding worldwide to be in excess of $80 billion at June 30, 2007. Over two-thirds are unlisted, over-the-counter instruments, with the remainder listed. The number and size of listed sukuk are increasing fast, the largest being that issued by Dubai-based Nakheel Group in early 2007 for $3.52 billion, listed in London and Dubai. As of Sept. 17, 2007, we rated $12 billion in sukuk outstanding listed on the world's markets, and we believe the volume of rated sukuk is set to rise due to the rapid development of this type of financing.

Through our rating of Sharia-compliant issuers and issues over a number of years, we believe we have demonstrated a deep and global understanding of Islamic finance. Standard & Poor's understands that in structuring sukuk, parties endeavor to ensure that:

- Rights and obligations of both the issuer and investors are clear and transparent, in compliance with the principle of Islamic finance that bans "gharar" (uncertainty);
- Income from securities is related to the purpose of the funding, and does not simply comprise interest payments--abiding by the principle that bans "riba" (usury or interest); and
- Securities issued are backed by yields derived from identified tangible underlying assets, according to the principle that all financial transactions must be asset backed, or at least asset based.

In light of these principles, sukuk lie on a continuum ranging from the lowest profit-sharing structures (typically guaranteed sukuk with a predetermined rate of profit ranking pari passu with the obligor's other obligations) to the highest profit-sharing structures (nonguaranteed sukuk behaving like ABS and issued by pass-through or pay-through vehicles.) In Arabic, "sukuk" is the plural, generic term for "notes," "certificates," or "bonds." In practice, the market now commonly uses the term generically to refer to debt instruments compliant with Sharia, or Islamic law. In this report, we identify three broad categories of sukuk, and describe our ratings approach for each.

Standard & Poor's Approach To Rating Sukuk Summarized

Our ratings are an opinion about the ability and willingness of an issuer to meet financial obligations in a timely manner, without commenting on Sharia compliance. The rating on an Islamic debt instrument varies depending on the degree of performance risk of the asset backing the transaction. Depending on the collateral type and transaction structure, the issue rating may be higher than the senior unsecured rating on the obligor.

There are various ways to structure sukuk: the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) lists 14 structures. In practice though, issuers have made use of only a handful of sukuk structures, including "ijara" (lease-back) deals and "musharaka" (co-ownership) contracts.

Notwithstanding the potential variety of sukuk structures, we group them into three broad categories:

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Sukuk with full credit-enhancement mechanisms

Under this structure, sukuk receive an irrevocable third-party guarantee, usually by a parent or original owner of the underlying collateral. The guarantor provides Sharia-compliant shortfall amounts in case the issuing vehicle (usually a special-purpose entity or SPE) cannot make payment. The ratings on this type of sukuk are largely dependent on the creditworthiness of the guarantor or the entity providing the credit enhancement mechanisms, as well as the ranking of the sukuk (usually senior unsecured) among other financial obligations of the guarantor.

Sukuk with no credit-enhancement mechanisms

Under this structure, sukuk resemble ABS in a securitization. The pool of underlying assets serves as the sole basis for coupon and principal payment. The ratings on these sukuk are largely based on the ability of the underlying assets to generate sufficient cash to meet, in a timely manner, the SPE's obligations. Standard & Poor's ratings, in this particular case, are based on the performance of the underlying assets under different stress scenarios along with the expected value of these assets at maturity.

Sukuk with partial credit-enhancement mechanisms

This structure combines features of both of the first two categories, with a third-party guarantee absorbing limited shortfalls from an otherwise asset-backed transaction. Our ratings approach depends on our estimate of the capacity of the underlying assets to meet the SPE's financial obligations as well as the terms of the guarantee and the creditworthiness of the guarantor.

To date, Standard & Poor's has assigned ratings to 23 sukuk issued by sovereigns, supranationals, regional governments, corporations, and financial institutions (see appendix 1). Most sukuk we rate benefit from full external guarantees, falling in the first category. We therefore have assigned them ratings equivalent to those on their guarantors and view them as ranking pari passu with the senior unsecured obligations of guarantors.

In the longer term, we foresee increasing issuance of more complex sukuk with no credit enhancement mechanisms, which would fall into the second category. More generally, we expect securitization, particularly in the Middle East, to increase and to take the form of Sharia-compliant structured transactions, giving rise to asset-backed sukuk notes with limited or no guarantee from the asset originator. The tranching of liabilities, a conventional securitization tool, is still under discussion among Sharia scholars regarding compliance, although a few tranched mortgage-backed sukuk have already been issued in Malaysia and the Gulf region, as well as asset-based subordinated sukuk.

Rating Sukuk With Full Credit-Enhancement Mechanisms: The Most Common Type of Rated Sukuk

Among credit-enhanced or guaranteed sukuk, Standard & Poor's rates "istisna" (project,) "mudharaba" (trust financing,) "musharaka" (co-ownership,) and "ijara" (leasing) structures. Ijara contracts so far have been the most popular form of sovereign-issued sukuk. For banks, musharaka contracts have been the most widely used and preferred route for issuing sukuk, as Islamic banks have only limited ownership of income-generating tangible assets to lease and lease back. Banks have therefore chosen to sell part of their credit and/or investment portfolios for the purpose of issuing sukuk. Usually, the seller of the underlying assets (the originator of these assets and guarantor) is also the manager or servicer.

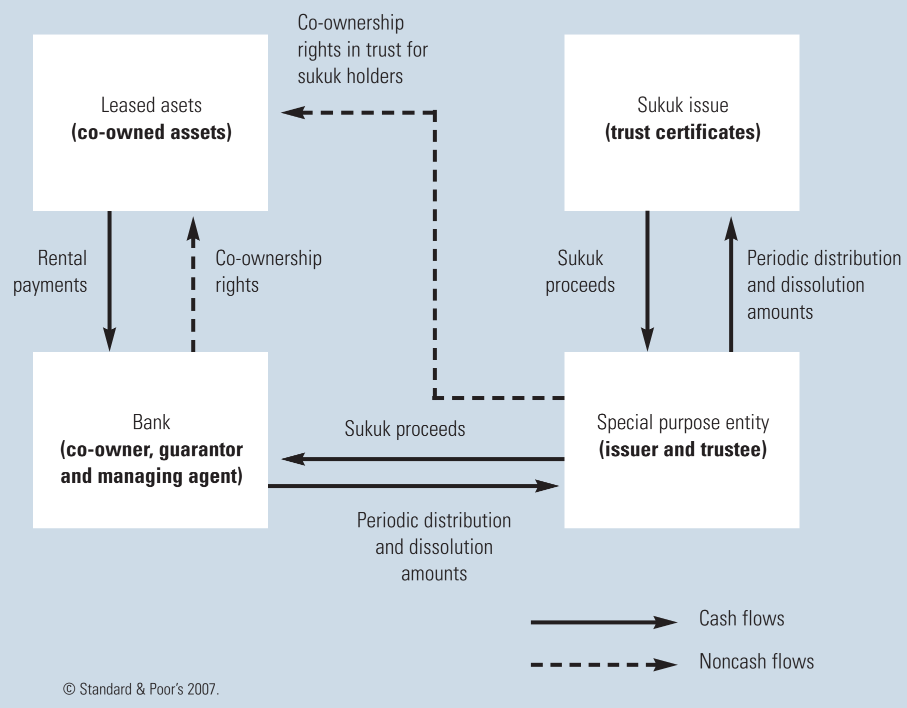
In rating guaranteed sukuk, we base our assessment on the creditworthiness of the guarantor. The guarantee covers not only the principal amount of the sukuk payable at the maturity date or in the case of predefined default events, but also the periodic payments

(coupons) from the SPE to sukuk holders. One of the most important factors in assigning ratings in this sukuk category is the level of seniority of the originator's guarantee and, more precisely, whether it ranks pari passu with all other similar obligations of the guarantor.

Example of fully guaranteed sukuk: sukuk al musharaka (co-ownership) issued by a bank

The transaction structure involves an SPE issuing musharaka sukuk. The proceeds of the sukuk will ultimately be used for a specific or general purpose by the bank, which sells a given percentage of a pool of assets to the issuer. These assets, originated, leased, and managed by the bank, are co-owned by both the bank and the issuer. The latter holds a given percentage of the co-owned assets in a trust capacity for the benefit of sukuk holders, owing to the proceeds received from the issuance of the trust certificates, and for a period of time corresponding to the duration of the sukuk. The pool of co-owned assets is in this case made up of leasing (ijara) contracts between the bank and its customers, pertaining to residential properties and other assets. The lease rental payments on the co-owned assets are collected by the bank as the managing agent of the assets, and serve as the basis for the floating periodic distribution payments payable on the trust certificates. On dissolution of the trust, the bank is to purchase the portion of the co-owned assets held by the issuer at the agreed exercise price, which will fund the dissolution distribution amount that is payable to the certificate holders and is equal to the principal of the sukuk (see chart 1.)

Chart 1: **EXAMPLE OF A FULLY GUARANTEED SUKUK**



The guarantee of the bank--simultaneously originator, managing agent, and guarantor--is the most important rating factor. The rating on the sukuk is equalized with our rating on senior unsecured debt of the bank, as guarantor. The equalization reflects the bank's obligation to make up for any shortfall if rental payments from the co-owned assets are insufficient to make the coupon payments. This obligation ranks pari passu with all other unsecured and unsubordinated obligations of the bank as guarantor. The dissolution amount payable on the trust certificates at the dissolution date is also dependent on an obligation of the bank. This

obligation is the irrevocable undertaking of the bank to purchase the issuer's portion of the co-owned assets at the agreed price. This structure was used by United Arab Emirates-based Sharjah Islamic Bank (BBB/Stable/A-2) for its five-year $255 million sukuk issued in 2006.

Rating Sukuk With No Credit-Enhancement Mechanisms: Less Common, But Expected To Emerge In The Future

The rating on this kind of sukuk would depend primarily on the ability of the underlying assets to generate enough cash flow to meet all of the issuer's financial obligations in a timely manner. In other words, the rating would depend mainly on the nature of the underlying assets. For example, if the underlying asset is a project, we would use our project finance methodology to estimate the value of the project and its ability to generate a sufficient amount of cash to pay the periodic installments and final principal repayment. Ratings on this kind of sukuk could be higher or lower than the ratings on the originator. We expect that this type of sukuk will become more popular in the foreseeable future in response to the huge number of projects in the planning stage, particularly in Gulf countries.

Changes to regulation in the Gulf could give a boost to this type of sukuk. Banks and regulators in the Gulf are currently considering enhancing the legal framework surrounding mortgage financing for both commercial and residential properties. In the longer run, once sufficient mortgage loan volumes are booked on banks' balance sheets, Islamic securitization will become more attractive. Given their quality, which can be tracked statistically, and high granularity, mortgage loan portfolios would become good candidates for asset-backing the issuance of nonguaranteed sukuk. Residential and commercial mortgage-backed sukuk have been so far limited in number; the most recent was Cagamas MBS Berhad's Malaysian ringgit (MYR) 2.11 billion Islamic RMBS issued in Malaysia in May 2007. Both conventional and Islamic financial institutions might increasingly turn to this category of sukuk in the future, especially if portfolios are built on a larger scale; credit information pertaining to them is collected, stored, and documented; and the underlying legal framework is supportive, particularly of the legal isolation of assets for the benefit of investors.

In rating this type of sukuk, we would likely focus on: (1) the ability of the underlying assets to generate enough cash to meet the SPE's sukuk payment obligations; (2) the capacity of the managing agent (often called "mudarib") to act as servicer and transfer payment from the obligors to the "rab el-maal" (investors); and (3) the expected value of the reinvested cash flows, compared with the principal amount of the sukuk. We would subject these three key elements to thorough analysis, based on modeling the behavior of the underlying mortgages and liquid instruments under different possible stress scenarios, as well as on documented assumptions about the recovery rates of the securitized asset classes. As for any other credit rating, we would also examine the supportiveness of the underlying legal framework, especially legal isolation of the assets from the originator's insolvency.

Rating Sukuk With Partial Credit-Enhancement Mechanisms: Requiring A Case-By-Case Approach Encompassing A Wider Range Of Analytical Steps

Partially credit-enhanced sukuk benefit from a third-party guarantee with respect to either periodic profit distributions or the principal amount, but not both. We see the partial guarantee as a mechanism enhancing the creditworthiness of the sukuk, but as such not providing enough for us to equalize the rating on the sukuk with that on the guarantor.

Our rating approach for this type of sukuk is therefore based on two elements:

- An assessment of the overall creditworthiness of the sukuk on a stand-alone basis, which means an evaluation of the ability of the underlying assets to generate sufficient cash flow to allow the issuing SPE to meet its financial obligations. This step is similar to our approach in rating nonguaranteed sukuk, and considers the position of the managing agent

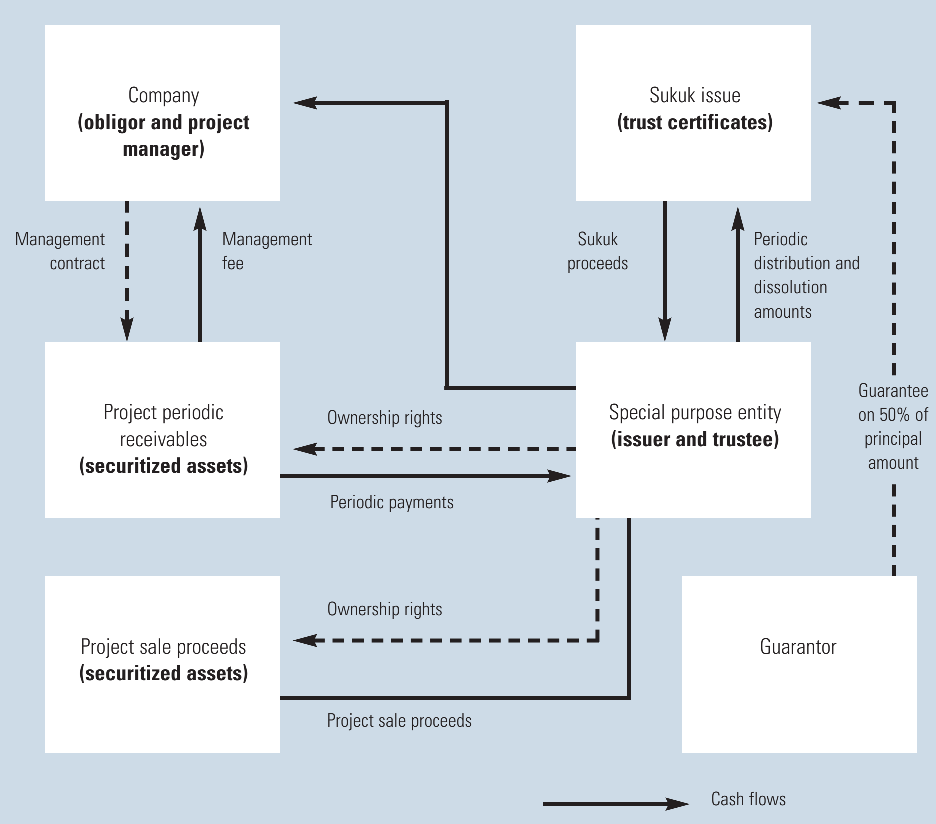
in relation to the extent to which nonperformance of its functions would affect the sukuk's credit quality.

- The stand-alone rating could then be notched up, depending on the nature of the guarantee and the implied enhancement to the sukuk's overall creditworthiness. We assess the capacity of the guarantor to provide timely support to the SPE in case of need, as well as enforceability of the guarantee. We might also place some emphasis on recovery analysis, whenever feasible. This form of analysis can help determine the probability of payment of sukuk holders if adverse events negatively affect the underlying assets or the obligor and/or managing agent, causing default or inability to service required cash flow transfers. In many of the jurisdictions where sukuk are issued, recovery analytics remain difficult to implement.

Example of a partially credit-enhanced sukuk: sukuk al istisna (project) involving an industrial issuer

The transaction involves an SPE issuing sukuk based on the securitization of existing and future project receivables originated by the obligor (see chart 2.) The proceeds from the sukuk are often used in this type of structure for funding specific items of plants and equipment or designated capital costs. Revenues collected from the project are the basis for the periodic distributions on the sukuk. On the dissolution of the trust and sale of the project, proceeds fund the dissolution distribution amount payable to the certificate holders, and are equal to the principal of the sukuk. The guarantor funds any shortfall, allowing the SPE to meet its obligations under the sukuk. The guarantee is provided in this case for 50% of the dissolution amount, and constitutes an enhancement factor for the ratings, and an additional comfort

Chart 2: **EXAMPLE OF A PARTIALLY CREDIT-ENHANCED SUKUK**



factor for sukuk holders.

The rating on istisna sukuk is based on the ability of the underlying assets to generate sufficient cash flow to meet debt service, expected value of the project at sukuk maturity, and also the credit enhancement provided by the partial external guarantee. The guarantor is committed to pay back up to 50% of the sukuk principal amount if the proceeds of the project sale fall short of the sukuk principal amount. Depending on the breadth of this partial credit-enhancement mechanism, we would assess how many notches to apply above the stand-alone rating on the sukuk. In this example, the guarantor does not guarantee the coupon payments.

Our Experience In Rating Sukuk In The Infrastructure Finance/Corporate World

Standard & Poor's has rated three sukuk in this particular field:

- The sukuk of National Central Cooling Co. PJSC (Tabreed; BBB-/Stable/--), issued by Tabreed 06 Financing Corp. Tabreed is an industrial company based in the United Arab Emirates (U.A.E.);
- The sukuk of DP World Ltd. (A+/Stable/A-1), issued by DP World Sukuk Ltd. DP World is also an industrial U.A.E.-based company; and
- The sukuk of Saad Trading Contracting and Financial Services Co. (STSFC; BBB+/Negative/A-2), issued by Golden Belt 1 B.S.C. STSFC is a Bahrain-based conglomerate.

The three sukuk have been structured differently, but have much in common with sukuk that have full credit-enhancement mechanisms. There are, nevertheless, some interesting differences in the way we analytically became comfortable with the ratings assigned to each of the individual sukuk.

Tabreed 06 Financing Corp. (BBB-)

The $200 million seven-year istisna and ijara sukuk is intended to fund the construction of district cooling plants in the U.A.E. by Tabreed. The sukuk issued by a 100%-owned SPE of Tabreed--Tabreed 06 Financing Corp--benefited from a purchase undertaking provided to the issuer by the parent. The purchase undertaking provides comfort that, in the event of insolvency of the issuer or payment shortfall, the parent has an irrevocable obligation to promptly pay all amounts due under the sukuk. We viewed this payment undertaking as equivalent to a guarantee, meaning that the sukuk could rank pari passu with Tabreed's senior unsecured corporate obligations. Had Tabreed's ratio of secured debt to assets been more than 20%, any unsecured debt would have been rated one notch below the counterparty credit rating (but when the sukuk was rated Tabreed's ratio was less than 20%.) Other features include the following:

- The trustee holds issuance proceeds in a transaction account in favor of the sukuk holders. The trustee also holds legal ownership over the assets in favor of the sukuk holders;
- A negative pledge over the assets is held by the trustee in favor of the sukuk holders; and
- The structure includes a cross-default clause and a cash waterfall structure linked to distributions, similar to those on Tabreed's other senior secured debt.

DP World Sukuk Ltd. (A+)

For DP World's 10-year $1.5 billion sukuk, the parent, DP World Ltd. provided a purchase undertaking to the 100%-owned SPE (borrower). The purchase undertaking's wording was similar to that of Tabreed's. This usually would have led us to equate the rating on the sukuk with that on DP World's corporate obligations, on the assumption that the sukuk had debt-

like features equivalent to those of unsecured debt. But because the instrument was structured as a trust-like sukuk--with periodic payments to sukuk holders funded from mudaraba (joint investment) assets, we instead viewed this sukuk as unguaranteed or otherwise unsupported issuance (excluding any potential role that government would play as 100% indirect owner of the parent.) Standard & Poor's concluded that the sukuk carried some equity-like, loss-absorbing features that would have rendered the debt issue potentially less equal on a ranking status compared with other unsecured debt at DP World Ltd. Ultimately, we did not need to question the ranking status of the sukuk relative to other financings. The reason was our counterparty credit rating of DP World Ltd. was based on strong implicit government support for the entity, and we considered that the purchase undertaking provided to DP World Sukuk from its parent also benefited from strong implicit government support. The rating also reflected the strength of the purchase undertaking, which implied that in the event of insufficient payments from the mudaraba assets to meet distributions the shortfall payments by DP World Ltd. would rank pari passu with payments to DP World Ltd.'s other unsecured creditors. All these factors led us to equalize the rating on the sukuk with the counterparty credit rating on DP World Ltd.

Golden Belt 1 B.S.C. (BBB+)

Golden Belt 1 B.S.C.'s $500 million five-year sukuk benefited from an unconditional and irrevocable undertaking by its 100% owner, STCFSC, to make rental payments on the leased assets plus the termination payment (principal) upon maturity of the sukuk. Due to the irrevocable nature of payments under the sublease agreement (just like that of the purchase undertakings in the DP World and Tabreed 06 sukuk,) we viewed the Golden Belt sukuk as ranking pari passu with all other unsecured and unsubordinated obligations of STCFSC. Given that STCFSC had no secured borrowings on its balance sheet, there was no issue of structural subordination and the rating was equalized with our long-term issuer credit rating on STCFSC.

Standard & Poor's expects to continue to rate this type of sukuk at the same level as the rating on the parent's senior unsecured obligations. Generally, if the investment-grade parent has a ratio of secured borrowings and other priority liabilities (for example, trade creditors to strong subsidiaries) to assets of more than 20%, then we would likely notch down the rating on the sukuk and on the parent's senior unsecured debt relative to our long-term issuer credit rating on the parent guarantor. On the other hand, if we have sufficient comfort in the security and/or the parent balance sheet consists largely of unsecured borrowings, then we would likely equalize the rating on the sukuk with the rating on the parent. In addition, if the parent guarantor has a strong implicit government-derived rating, then we could factor in government involvement into our assessment of the sukuk financing at the SPE.

Legal Considerations

Standard & Poor's also takes into account the relevant legal and jurisdictional aspects of the transaction in rating a sukuk--no matter what kind. To understand the impact of the underlying legal framework on the ability and willingness of the issuer to make payments on the rated instruments, we may request legal opinions of counsel to analyze the relevant legal issues, such as enforceability, recognition of choice of law, and, particularly in the context of nonguaranteed sukuk, insolvency and security-related matters. Some jurisdictions have features that could prevent us from granting high ratings on sukuk. For example, a number of jurisdictions in the Middle East raise questions about which parties' obligations would be enforceable in local courts, whether they would recognize contractual governing law (for example, in Saudi Arabia), and whether security would be enforceable. Sometimes uncertainties pertaining to the legal environment surrounding sukuk issuances are simply due to the fact that the relevant legal framework has so far been untested, because the laws have been so new and defaults lacking.

Structured Finance In The Middle East: Promising Indicators For Development

The indicators for a structured finance market in the Middle East are promising. Capital markets are developing, legal frameworks that could enable securitization are being implanted, and originators are working out how best to securitize assets. Standard & Poor's Ratings Services has seen growing interest and increasing numbers of enquiries as confidence in this form of financing grows.

There are, of course, certain hurdles to the development of any new structured finance market and the Middle East is no exception. These include legal issues, high liquidity in the region, and a lack of benchmarks. We are, though, confident that in the coming years originators in the Middle East will increasingly turn to securitization to fund their business activities.

Our focus here is on the regions that we consider to have the greatest likelihood of seeing a structured finance transaction in the near future. Although we discuss the Middle East in general, our focal point is on the United Arab Emirates (UAE), Bahrain, and Saudi Arabia.

Readers familiar with Islamic finance will be aware of the body of articles we have published on the subject (see "Related Articles" below). This article does not aim to replicate any of that work but here we will briefly place securitization, and the wider concept of structured finance, within the Islamic finance definition. Put simply, Islamic finance can apply to any product that has been issued with a fatwa, or edict, from a board of Sharia scholars. An example is "sukuk" (bonds), which are a close relation to securitization bonds in that they are usually issued by an SPE (special-purpose entity) and somewhat asset-backed, but are Sharia-compliant. Therefore, if a securitization was granted a fatwa it would be an Islamic product. Equally, one could have a structured finance product that is not Sharia compliant, but the underlying assets could be. Or it may be that sukuk are issued from the structured transaction. Regardless of the structure presented to us to analyze and rate, readers should note that we do not comment on whether a bond is Sharia compliant.

What Is Driving Middle Eastern Securitization?

We have noticed increased interest from originators, governments, and investors regarding securitization in the Middle East. Given that one of the main incentives for securitization is cheaper funding, this interest may seem unusual in capital markets awash with liquidity from the oil markets. There is, however, a dependence on oil, meaning that the capital markets' liquidity is linked to how the oil markets are performing.

Furthermore, at this point in time the incentive to securitize is also limited because banks collateralizing their high-yielding retail loans in securitizations may find it difficult to replace these loans on their balance-sheets with other asset classes that have margins that are as attractive.

It is likely, therefore, that the main incentive to securitize may be linked to the need to diversify the region's investor base.

New Developments: Financial Centers And Legislation Lay Ground For Securitization

Two key new developments in the Middle East are laying the foundations for a potential securitization market.

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The first is the trend in the region towards developing financial centers, such as the Dubai International Financial Centre (DIFC) and the Qatar Financial Center, which aim to diversify the investor base and bring in foreign money and investors.

The DIFC, for example, is a positive factor for the broader securitization framework in the Emirate. Described as a Federal Financial Free Zone, advantages that it brings include a zero tax rate on profits, guaranteed for 50 years; the possibility of 100% foreign ownership; and no restrictions on foreign exchange or repatriation of capital. These features add liquidity to the market by easing access for foreign investors. Another core benefit we see is that it has based its legal framework on those of Europe, North America, and the Far East, making the law more familiar to international structured finance bankers and investors.

This latter benefit speaks to the second development in the region we have seen, that of new legal frameworks, as several countries have made efforts towards formalizing laws that could encourage securitization.

New mortgage legislation being introduced in Saudi Arabia is a case in point. This could possibly be in effect by the end of 2007 and is expected to stimulate demand for private sector mortgage loans, previously not freely available. As a growing population embraces home ownership this will stimulate house building. In turn, a greater supply of housing stock should stimulate further demand for new mortgages.

Another legislative change involves restrictions on foreign ownership of properties in Dubai and Saudi Arabia being relaxed, which could also help the securitization market. With foreigners able to own property in the region, the potential pool of owners is potentially greater and this too could stimulate growth in the mortgage markets.

A viable securitization market requires a regular flow of cash paying assets, such as mortgage loans. New laws that encourage both home ownership and hence mortgage borrowing are likely to provide a platform for a securitization market.

Outlook: Much Potential If Hurdles Are Overcome

Our outlook for structured finance growth in the region is positive, but volumes are expected to be relatively small in the short term. Governments are implementing new laws that are expected to encourage the securitization of assets, originators are working on securitizing assets in the region, and the general demand worldwide for securitized assets by investors is high. The outlook is strengthened by the comparative ease that securitization brings to investing in assets that would normally be hard to gain exposure to. These include retail and commercial property/loans, auto loans, and credit cards. Rated securitizations allow investors to gain exposure to these asset classes in markets that are traditionally unfamiliar to them.

However, the Middle East is an area where liquidity is very high and therefore securitization may not be the cheapest way to raise capital, especially for the first few transactions. In order to grow, securitization must offer more than just a cheap means to finance asset pools.

Our structured finance department has received enquiries about RMBS, auto and consumer loan ABS, and CMBS transactions. With each new asset class we expect interest to continue to rise. We have rated one RMBS transaction (ENSeC Home Finance Pool I Ltd.; previously rated ‘AAA’, now redeemed), although our rating was not based on “asset isolation”, that is, a so-called “true sale” of the assets as is typically seen in Western Europe and U.S. securitizations. However, as the market is evolving, we are observing a growing interest from market participants in true sale securitizations and corresponding transactions not linked to the originator or government and not cash-collateralized.

Economic Overview: Moves To Become Less Reliant On Oil

The Middle East has high liquidity due to high energy prices. However, most economies in

the region intend to become less reliant on oil-based growth in the future, as can be seen in moves by governments to invest in non-oil-based sectors and infrastructures.

Table 1 shows that in recent years non-oil GDP growth in Bahrain, Saudi Arabia, and the UAE has been relatively high compared with oil-based growth. However, it is widely accepted that petrocarbons and government spending remain the key drivers for the economy in the region.

Table 1: **REAL GDP GROWTH**

	Average 1998-2002	2002	2003	2004	2005	Estimated 2006	Projected 2007
Bahrain							
Actual	4.8	5.2	7.2	5.4	6.9	7.1	6.3
Non-oil	4.4	6.0	8.3	8.6	9.0	8.0	7.0
Oil	7.3	1.3	1.1	(11.5)	(7.6)	0.3	0.3
Difference	(2.5)	3.9	6.1	16.9	14.5	6.8	6.0
Saudi Arabia							
Actual	1.5	0.1	7.7	5.3	6.6	5.8	6.5
Non-oil	3.2	3.7	3.7	4.6	6.8	7.8	7.6
Oil	(1.8)	(7.5)	17.2	6.7	5.9	1.6	4.1
Difference	3.3	7.6	(9.5)	(1.4)	0.7	4.2	2.4
UAE							
Actual	4.0	2.6	11.9	9.7	8.5	11.5	5.8
Non-oil	7.0	7.7	11.2	12.6	11	10.5	6.6
Oil	(1.3)	(7.6)	13.6	2.9	2.1	14.1	3.5
Difference	5.3	10.2	(1.7)	6.8	6.4	(2.6)	2.3
GCC actual	2.5	1.6	8.5	6.6	7.1	7.2	6.1

Source: IMF.

Despite governments' efforts to diversify revenue, though, their budgets are still reliant upon oil, which in turn is triggering multiplier effects in the private sector, particularly in construction, infrastructure, and downstream oil industries such as petrochemicals. Growth across the region thus appears set to continue, with oil-based revenues in the short to medium term still driving this.

Geopolitical risks are key to sovereign ratings but high interest in new corporate ratings

The sovereign ratings in the region are supported mainly by governments' balance-sheet strengths and external liquidity. The transformation of Gulf Cooperation Council (GCC) economies to better-diversified, private-sector-led economies is thus a long-term aspiration that has only a marginal immediate impact on the sovereign's credit ratings. More significant in the near-term is the impact of geopolitical risk, which remains the principal constraint on GCC sovereign ratings.

The sovereign ratings perspective in the region will largely depend on the evolution of key geopolitical risks, including the situation in Iraq, tensions between the West and Iran, and, to a lesser extent, developments in Lebanon. The balance-sheet strength of the rated GCC states means that the possibility of these risks materially affecting the sovereign's creditworthiness, even were they to materialize, is in practice small. Nevertheless, these risks differentiate the GCC states from higher-rated sovereigns, and the positive ratings prospects for most will continue to be tempered by the higher-risk political environment that prevails in the region.

New corporate ratings in the region are increasing year on year, with ratings assigned in 2006 more than doubling, and, by April 1, 2007, the volume was already almost twice that of 2006. The initial issuers in this area were the diversified holding companies; however, the second wave of issuers is expected to be from sectors such as:

- Real estate/property developers,
- Telecoms,
- Oil and gas,
- Chemicals,
- Transportation, and
- Subsidiaries of diversified holding companies.

Project finance also continues to show large potential in the Middle East, which is globally one of the largest project finance markets. Increasingly, projects are looking to the bond markets as an alternative funding source. The involvement of sovereign related or fully owned sponsors drives the expectation for high ratings based on the sovereign rating rather than the individual strengths and weaknesses of the project. There is some contradiction in this in that many are structured on a non-recourse basis while aiming to achieve full benefit from the sponsor's implicit support.

Market Characteristics: Credit Growth Provides Source Of New Assets

Mortgage market

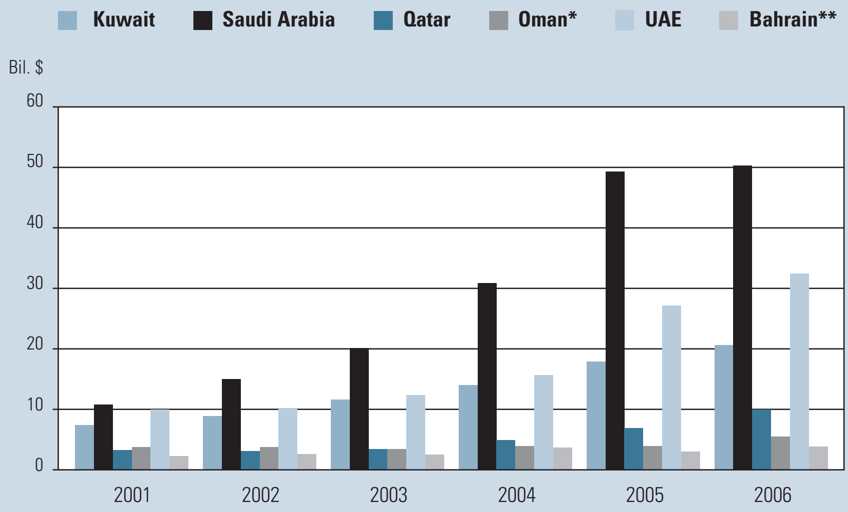
New mortgage laws in Saudi Arabia are likely to enable a mortgage market to emerge, partly funded by the private sector. However, the extra houses that will need to be built in the future are not the only influence on new mortgage origination. Mortgage growth will also probably come from financing the purchase of houses already built and furthermore there is likely to be the option of re-financing existing homes and using the funds for anything from home improvements to setting up new businesses. In turn, this may stimulate commercial properties as new businesses are formed.

The change in mortgage laws in Saudi Arabia and the change allowing foreign ownership of land and property in certain areas of the UAE from 2003, broaden the investor base for residential and commercial properties, stimulating demand for both property types. However, in both cases how these foreign ownership laws will be applied for foreign SPEs is still untested as there are no precedents. It is also worth noting that in Qatar and Bahrain foreigners can also buy properties in selected areas.

Credit growth

There is very little data across the Middle East region that breaks down consumer loans into categories such as mortgages, credit card loans, or auto leases/loans, but we do have general consumer credit information. There has been impressive credit growth in the region, most notably in 2005, which to a large degree continued in 2006, for the first half of the year at least (see chart 1). Early expectations of consumer credit growth in 2007 are fairly conservative because of lower household disposable income, principally because the GCC region was hit by a negative wealth effect after the local stock market crash in 2006. Regulations on personal lending in several GCC countries, such as Saudi Arabia and Kuwait, have also become more restrictive. These factors also probably explain the slowdown seen in the second half of 2006.

Chart 1: **RETAIL LOANS IN THE GCC**



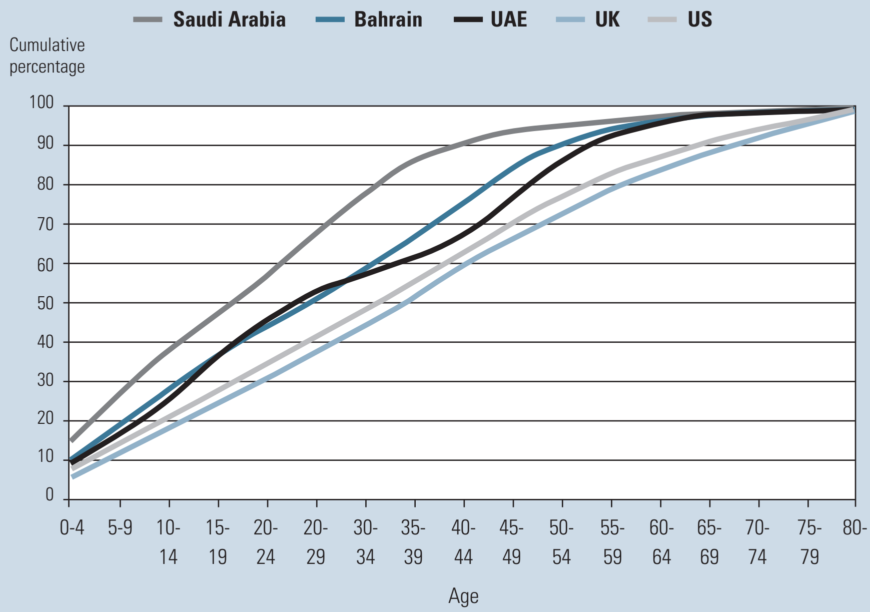
*Projected year-end figure for 2006. **Excluding wholesale and Islamic banks.

Saudi Arabia's comparatively large (27.6 million, including 5.6 million non-nationals) and growing population, as well as its young demographic, will likely cause a corresponding increasing demand for credit for housing, cars, commercial property, and other consumer assets.

As chart 2 shows, a large percentage of Saudi Arabia's population is under the age of 35 (79%), which should facilitate growth in demand for properties as more people enter the homeownership market than are leaving it. This percentage is lower in Bahrain and the UAE (each about 59%). However, this is still approximately 10 percentage points and 15 percentage points higher than the more seasoned U.S. and U.K. markets, respectively, which also have more developed homeownership structures.

Bankers may choose to finance this growing consumer credit via a securitization, because despite the high liquidity in the area they may be looking to broaden their investor base. A hurdle to any securitization, though, is size: before securitizing, banks need to build sufficiently large portfolios.

Chart 2: **CUMULATIVE AGE DISTRIBUTIONS**



Rating Challenges: Securitization Processes And Procedures Are New Concepts

Given the unique and varied nature of the Middle East in terms of its financial markets, investor base, and culture, it is difficult to compare it to any other region. Unlike typical emerging markets, many economies in the Middle East are well developed, with per capita GDP comparable with those of the U.S. or Western Europe. However, despite the unique cultural, economic, and political influences on the financial systems in the Middle East, certain broad concepts and risks are common to all capital markets where securitization is underdeveloped.

T&C (transfer and convertibility)

Our T&C assessments reflect our opinion of the probability that a sovereign will restrict access to foreign currency by non-sovereign entities required to service debt outside the country. We also assess the risk that the sovereign would interfere in a specific transaction, either directly or indirectly. We take T&C assessments into account when rating a securitization because clear access to funds is a key feature of any structured finance transaction. Table 2 shows the current T&C assessments for the region.

Table 2: **T&C ASSESSMENTS FOR SELECT MIDDLE EASTERN COUNTRIES**

Country	T&C assessment
Kingdom of Bahrain	AA-
Hashemite Kingdom of Jordan	BBB-
State of Kuwait	AA+
Republic of Lebanon	B+
Sultanate of Oman	AA-
State of Qatar	AA+
Kingdom of Saudi Arabia	AA+

Performance data

An important factor in rating a securitization is how the pool of assets is likely to perform. One way to assess this is to look at the historical performance of the pool or, for newly originated assets, to look at assets with similar characteristics. We assess performance by looking at the different vintages (the year the asset or loan was originated) and their loss and recovery rates. If the data we receive is of poor quality or of a small sample size, stresses we apply will necessarily be greater. As banks' performance data in the region is traditionally very confidential, it is difficult to make comparisons and assess underwriting standards. This may mean we apply greater stresses in our analysis.

Concentration

Concentration risk arises when all the assets are originated from a small area. If the pool is not suitably geographically diverse, then a local economic downturn can adversely affect the cash flow from the mortgage pool.

Many of the countries in the region are quite small, with population sizes less than that of London, for example. Bahrain, for instance, has a population of approximately 720,000. Even the UAE with a population of about 4.1 million is smaller than some regions in the U.K. that we stress for concentration risk.

This means that the concentration risk when looking at portfolios from such small areas is comparatively large, especially if multiple securitizations have come from the same area. This could inhibit securitization in these countries, although pooling of assets from different areas until a critical mass is formed might be an option for some banks.

Third-party support

Securitization processes and procedures are relatively new to the Middle Eastern market. As part of the rating process we would visit each originator and assess how it operates, is managed, and underwrites and services its loans. In new securitization markets, however, benchmarks in these areas are hard to calculate and specialist third-party servicers are less established. This lack of observable experience applies also to other third-party support functions, including security agents, corporate servicers, and other peripheral firms providing support. Furthermore, in some markets where there is no concept of security or trust laws, these duties will more than likely fall on agents. Securitization structures from the Middle East need to address these concerns.

Securitization Has Its Place In Islamic Finance

Islamic finance has many qualities that could lend themselves to securitization as a means of raising funds. Sharia-compliant finance tools must have asset-driven returns (whether it is one asset or several assets), for example, which is a notable feature of securitization. Although

sukuk are based on assets and usually issued via an SPE, it should not be confused with a true sale securitization, as often they are dependant on cash flows from the issuing corporate or bank. That said, theoretically one could issue a sukuk out of a securitization.

Numerous asset-based sukuk have been issued recently. In particular, there have been several co-ownership ("musharaka") sukuk, such as the $225 million sukuk issued by Sharjah Islamic Bank and rated 'BBB' , the $750 million sukuk issued by Dubai Islamic Bank and rated 'A', and the $1 billion sukuk program of Emirates Islamic Bank PJSC and rated 'A'. More recently we have seen a co-investment ("mudaraba") sukuk structure issued by Dubai Sukuk Centre Ltd.

However, the ratings on these bonds have been based on full and senior unsecured guarantees provided by rated entities, usually the originator, apart from the Emirates Islamic Bank program which is guaranteed by Emirates Bank International PJSC (A/Positive/A-1). Even the coupons (periodic distribution amounts) have been guaranteed by a Sharia-compliant liquidity facility made available by the obligor/originator or the guarantor to the issuer. This means that the rating is weak linked to the supporting counterparty and not the underlying pool of assets as in a true sale securitization.

By way of definition, securitization is a means of parceling risk into packages that can be sold to investors with a particular appetite for that risk, or even engineered to create the risk with which a specific investor would like to balance its portfolio. Islamic finance is based on the investors receiving their portion of the profits/rental incomes on the pool and thus sharing the risk pro rata to their investment. This makes the possibility of tranching the liabilities structure a source of debate, and could be a limiting factor to a full-scale securitization market if the bonds issued from the SPE need to be Sharia compliant. At the moment there have been no signals from the Middle East market as to how this will progress.

As the principles of Sharia do not allow the conventional hedging of risk many of the traditional hedging tools used in structuring transactions are not usable in their current form. Hedging involves using structural features like swaps to mitigate certain risks, such as any basis risk that may arise between the coupons on the notes and the coupons on the underlying assets or any currency risk if the notes are issued in different currencies. The lack of conventional hedging should encourage investment bankers and financial engineers to come up with new and innovative tools to structure these products.

We remind readers that our ratings do not address in any way whether or not a rated instrument is in compliance with Sharia principles (which is a matter for Sharia boards). A rating reflects our current opinion of the likelihood that debt service payments will be made on a timely basis in accordance with the terms of the rated instrument. A rating also does not constitute a recommendation to buy, sell, or hold a particular security; nor does a rating comment on the suitability of an investment for a particular investor.

Legal Frameworks Could Present Challenges

The different legal frameworks across the Middle Eastern region present a number of potential challenges compared with some of the conventional securitization structures seen in other markets.

For instance, difficulties exist to obtaining effective and enforceable security interests and there is a lack of a developed bankruptcy/insolvency legal regimes in some jurisdictions. These deficiencies may place obstacles in the way of establishing bankruptcy-remoteness—in the conventional sense—to our rating standard, a key feature of securitizations.

Similarly, restrictions in some jurisdictions on externalizing ownership of assets may place impediments in the way of structures that aim to achieve bankruptcy-remoteness through the use of true sale transfers of assets to off-shore SPEs.

The Sharia prohibitions on things such as interest ("riba"), gambling ("qimar"), games of

chance involving speculation ("maysii"), and so on seem likely to restrict opportunities for some of the financial derivatives and hedging activities seen in other markets, and thus make synthetic securitization structures more difficult to implement.

On the other hand, some Islamic financing structures, particularly those which concentrate on the ownership of assets and in particular ijara sukuk, appear to have much in common with true sale securitization structures. Significantly, the burgeoning Middle Eastern market for project financing has successfully addressed and managed similar issues.

Developments in the legal regimes in various jurisdictions throughout the region seem to indicate a willingness to facilitate certain types of structure familiar in other securitization and structured finance markets. As well as the new mortgage legislation being introduced in Saudi Arabia, the introduction of the foreign ownership laws in Dubai and Saudi Arabia are some examples of this.

The launch of the Qatar Financial Centre's Civil and Commercial Court is also a positive legal development and may be seen as a further indication of the region's growing focus on international capital markets and related legal frameworks.

Building On Experience To Support Development

Securitization in the Middle East is likely to broadly follow the core principles of the established true sale structured finance markets of Europe and the U.S. However, as discussed in this article some of the methods used will be slightly different to address local laws and Sharia principles. Each transaction is going to take a lot of thought, time, and effort in the short term.

We are committed to supporting the development of the Middle Eastern capital markets and are in the process of opening a permanent office in Dubai.

Our strong reputation in this region has been established in many of our traditional practices—banking, corporates, sovereigns, and indices (most notably the S&P GCC Index Series and S&P Shariah GCC Index), as well as in project finance. Within the structured finance team we will strive to fuse this knowledge, expertise, and network with our own experience, ensuring that we are well positioned to analyze and rate any new securitizations.

We look forward to working with originators, issuers, arrangers, and their advisors, building upon existing technology, as they adapt existing securitization, structured finance, project finance, and Islamic finance tools to develop securitization structures appropriate for the Middle Eastern region. We encourage readers who are structuring or considering structuring a Middle Eastern securitization to contact us as early as possible in the process to discuss any points arising.

Risk Management For Islamic Financial Institutions: A Rating Perspective

Analyzing different risk categories and their management is a critical step in assessing the creditworthiness of all types of banks. Overall, there is no material difference between our analysis of the risks and enterprise risk management of Islamic banks and of conventional ones. However, the former display unique features--relating to credit, market, funding and liquidity, and other risks--that need to be considered and which have an impact on our rating process. Profit-sharing investment accounts (PSIAs), liquidity management, real estate exposure, and operational risks are among the elements that we focus on when assessing the creditworthiness of an Islamic financial institution (IFI).

Over the past decade, Standard & Poor's Ratings Services has developed strong expertise in the field of Islamic finance. We have adapted and refined our rating methodology to address the specifics of operations carried out by IFIs. It is important to note, however, that our opinions relate only to the creditworthiness of an IFI or a specific debt instrument, not to its degree of compliance with Sharia.

Credit Risk: First Lien Access To Collateral But Foreclosure Is Difficult

One of the five pillars of Islamic finance (see appendix), the obligation to back any transaction by a tangible, identifiable, underlying asset, means that IFIs--at least in theory--back their transactions with collateral. Consequently, collateral coverage is usually higher for IFIs than for conventional banks.

Contrary to conventional banks, whose customers are not obliged to disclose the purpose of their borrowings, Islamic banks finance the acquisition of identifiable assets of which they have legal ownership, in most cases, until maturity and final repayment. This is notably the case for "ijara" (lease financing) operations, in which the bank acquires the asset and leases it to the customer, with ownership transfer taking place only at maturity. The bank, as the legal owner of the asset, is therefore in a favorable position to foreclose on this asset (in the case of a default), and sell it on a secondary market.

In practice, however, collateral foreclosure can be much more difficult, especially for residential real estate. Given the take-off in residential real estate lending in Gulf Cooperation Council (GCC) countries, this question of foreclosure is set to become critical (including for Sharia-compliant securitization). Although an Islamic bank is in theory in a position to evict a customer from a property and resell it in the case of a default on the loan backed by the property, this would be unlikely to happen in practice owing to its "social responsibility". There are, however, instances when such a decision may be taken by a bank and authorized by its Sharia board--notably when specific conditions were set out and agreed upon before the conclusion of the transaction. In such cases, foreclosure may be easier than for conventional banks, as the property belongs to the Islamic bank. As a matter of fact, this type of structuring is sometimes used by conventional banks, as it is a strong way of reducing the problem of foreclosure. However, when the financing is based on other Sharia-compliant schemes where the property is not registered in the bank's name, the IFI will find itself in the same position as its conventional peers.

Certain transactions carried out by Islamic banks can bear above-average credit risk. For instance, some Islamic banks are involved in "musharaka" (venture capital financing) and "mudaraba" (trust financing), which are equivalent to participation transactions, increasing

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the risks carried by the bank. In addition, in "murabaha" (mark-up financing) and ijara, the existence of full collateral could lead Islamic banks to be less vigilant when assessing the creditworthiness of their borrowers.

The credit risk of an IFI can also be influenced by the way its operations are funded. Under Accounting and Auditing Organisation for Islamic Finance Institutions (AAOIFI) reporting standards, there is a clear separation between assets financed through equity and assets financed through PSIAs. One example of this can be found in the financials of Shamil Bank of Bahrain (BBB-/Stable/A-3). In the case of a default on some assets financed through PSIAs, the holders are, in theory, supposed to share in the losses. Thus, funding a loan portfolio through PSIAs could be viewed as a partial transfer of credit risk from an IFI to PSIA holders. However, in practice there is a strong incentive for the bank to take the hit through a reduction of its "mudarib" fee (for acting as a manager of PSIAs) or through its reserves. Indeed, a loss could trigger some PSIA holders to withdraw their funds, which could translate into liquidity problems. Standard & Poor's believes that IFIs would be inclined to support PSIA holders in the case of issues related to the credit quality of the underlying portfolio. Therefore, the loss-absorbing nature of these instruments is not completely certain.

Market Risks: Structured Products Are Generally Forbidden And Hedging Instruments Are Limited

The management of market risks is made more difficult for Islamic banks due to the limited number of risk management tools/instruments available to them. For example, it is difficult for an IFI to use hedging instruments such as derivatives as they are generally forbidden. On a positive note, the prohibition of "gharar" (speculation) usually tempers the risk profile of Islamic banks simply by limiting the size of their trading operations. Market risk for IFIs can be divided into three categories:

- Margin risk. This results from a mismatch between the yield earned on the bank's assets and that served on its liabilities. For instance, a bank can find itself exposed to margin risk when a portfolio of murabaha (with fixed margins) is financed through PSIAs (with variable margins). As Islamic scholars usually forbid recourse to derivatives, this risk can be difficult to hedge. In some cases, IFIs can employ nascent Sharia-compliant hedging techniques. Dubai Islamic Bank (DIB; A/Stable/A-1) and Deutsche Bank AG (AA/Stable/A-1+) have stated that they have established the first ever Sharia-compliant profit rate collar. For less sophisticated IFIs, the matching of floating and fixed yields can be used as a natural way to cover these risks. An ijara portfolio--with a floating margin or repricing characteristics--could be used to reduce an IFI's exposure to margin risk resulting from the use of PSIAs as a funding source. As IFIs usually benefit from a large portion of unremunerated deposits, as is the case for Saudi Arabia-based Al Rajhi Bank (A/Stable/A-1), this can also be a good mitigating factor for margin-related risks.
- Investment risk. IFIs are forbidden from speculating, which means that trading risk is limited. In addition, as most complex structured products are usually not considered Sharia compliant, IFIs cannot invest in them. The exposure of IFIs to investment risk is therefore limited to that stemming from equity markets, Sharia-compliant debt products (such as sukuk), and real estate. Given that the secondary market for sukuk is very limited, the risk relating to these instruments mainly stems from credit quality rather than from market movements. Although IFIs that invest in stock markets are exposed to swings in equity prices, direct exposure to these markets is usually limited. We have seen some opportunistic investments made by IFIs over the past three years in order to benefit from the boom in GCC stock markets, but the correction that took place in 2006 provided a strong incentive to limit these exposures. IFIs are usually significantly exposed to the real estate sector, as it

is compliant with Sharia principles. Some Islamic banks in the GCC have significant exposure to this sector (directly or indirectly through collateral), which is negatively factored into our ratings. DIB is an example of such a bank, with significant direct and indirect exposure to real estate.

- Foreign exchange risk. As for conventional banks operating in emerging markets, IFIs' exposure to foreign exchange risk can be harmful. While conventional banks can easily hedge themselves through swaps or other hedging instruments, these are generally forbidden in Islamic finance, making the situation more challenging for IFIs. For the time being, this risk is limited for banks operating in GCC states as their currencies are pegged to the dollar (except for Kuwait).

Funding And Liquidity Risk: PSIAs Are A Unique Feature Of Islamic Banks

Liquidity is one of the most critical issues for IFIs, as only a small secondary market exists to enable them to manage their liquidity. Their assets are generally not sellable on a secondary market and they cannot invest in fixed-income instruments for treasury management purposes. This fact is all the more damaging for them as, in the Gulf region, sovereigns have been using local and foreign currency conventional debt as a means of actively managing their financing needs, and non-Islamic banks have been major subscribers as returns have been attractive. A key development in this area has been the formation in Bahrain, in 2002, of the International Islamic Financial Market (IIFM), whose aim is to create and standardize financial instruments to meet the liquidity needs of IFIs around the world. In addition, some leading Islamic banks have set up bilateral agreements with their respective central banks in order to address this weakness. This is notably the case for Al Rajhi Bank, which has an investment portfolio that can be repoed with the Saudi Arabia Monetary Agency (SAMA).

Many Islamic banks offer PSIAs to their customers. These financial instruments are relatively similar to the time deposits of conventional banks. The terms and conditions of PSIAs provide for depositors being entitled to receive a share of the bank's profits, but also obliged to bear potential losses pertaining to their investment in the bank. This profit-sharing principle--according to which investors and entrepreneurs must share the risks and rewards of a given venture--is core to and one of the five pillars of Islamic finance (see appendix). It translates into a displaced commercial risk, however, and could result in a liquidity stress should PSIA holders decide to withdraw their deposits at maturity. This risk could be triggered by the inability of an IFI to provide these depositors with returns that are relatively similar to competitors' (conventional or Islamic). Several layers of protection have been developed by some IFIs, however:

- Profit equalization reserves (PERs). These reserves constituted by IFIs can be used to smooth returns offered to PSIA holders in cases of reduced distributable cash flows. For instance, if an Islamic bank realizes an effective profit that is not sufficient to offer its PSIA holders a satisfactory return, it could use part or all of its PER to boost the return and maintain its deposit base. PERs are deducted from a bank's gross profit before allocating the mudarib fee.
- Mudarib fee. This is the remuneration of the bank for acting as a manager (mudarib) of PSIAs. The mudarib fee is not fixed and differs from one bank to another, but is typically between 20% and 40% of the distributable cash flows. This can provide a bank with some room for maneuver in case of unexpected profitability deterioration; it could simply decide to waive its fee, allowing a higher remuneration to PSIA holders.
- Investment risk reserves (IRRs). These are reserves constituted by IFIs in order to curb the risk of future unexpected losses and enable them to be in a position to support PSIA holders should such losses occur. IRRs are set aside by IFIs after allocating the mudarib fee.
- Liquidity. IFIs offering PSIAs are in general more liquid than conventional banks as they

are aware that their reliance on PSIAs could trigger liquidity stress. The average liquid-to-total assets ratio for GCC-based IFIs rated by Standard & Poor's was 30% at midyear 2007, compared with 18.1% for GCC-based conventional peers. This extra liquidity has a negative impact on profitability, however. Some leading Islamic banks have a portfolio of assets that can be repoed with their central bank.

IFIs can diversify their funding sources through wholesale funds such as sukuk. Issuance of these instruments has increased rapidly over the past three years, reaching almost $100 billion at Dec. 31, 2007. Sukuk offer a longer term and more stable source of funding. We expect the sukuk market to continue to grow, as IFIs need to increase their stable funding to cope with the opportunities emerging in their markets, notably in mortgage lending.

Other Risks: Typical To IFIs And Equally Important

Standard & Poor's identifies two main risks in this category: reputation and human resources (a shortage of qualified staff).

Reputation risk could arise related to the interpretation of Sharia and differences between fatwa (opinions of Sharia boards regarding the Sharia compliance of specific transactions). As already stated, Standard & Poor's does not provide any opinion on the Sharia compliance of a product or a given financial institution, but the risk of being perceived as non-Sharia compliant could severely damage the creditworthiness of an IFI. For instance, Muslim depositors might withdraw their funds from a bank, triggering a liquidity crisis. Retail customers that are mainly attracted by the Islamic nature of a bank might also stop requesting loans from this institution, triggering a downturn in profitability. Reputation risk can also arise from the perception of a link of an IFI with unlawful financing. In the aftermath of Sept. 11, 2001, IFIs made a lot of investments in their know-your-customer (KYC) systems and anti-money-laundering (AML) procedures in order to curb this risk, however.

The shortage of skilled human resources is becoming a bigger concern for the industry. The strong growth in Islamic finance over the past decade and the creation of new IFIs means that having and maintaining qualified human resources is becoming very challenging. This risk may result in management discontinuity and ultimately damage the creditworthiness of an IFI. On a positive note, we have noticed that some professional "qualifications" in Islamic finance have been created. This should ease the pressure on the industry in the medium term.

Appendix: The Five Pillars Of Islamic Finance

IFIs have to abide by the five pillars of Islamic finance, which are:

- The ban on interest: Interest must not be charged or paid on any financial transaction, as interest (or the intrinsic value of the money) is deemed unlawful by Sharia.
- The ban on uncertainty or speculation: Uncertainty in contractual terms and conditions is forbidden. However, risk taking is allowed when all the terms and conditions are clear and known to all parties.
- The ban on financing certain economic sectors: Financing of industries deemed unlawful by Sharia--such as weapons, pork, and gambling--is forbidden.
- The profit- and loss-sharing principle: Parties to a financial transaction must share in the risks and rewards attached to it.
- The asset-backing principle: Each financial transaction must refer to a tangible, identifiable underlying asset.

S&P Launches Stability Ratings For Islamic Banks Offering Profit-Sharing Investment Accounts

Most Islamic banks offer profit-sharing investment accounts to their customers. PSIAs are financial instruments that are relatively similar to the time deposits of conventional banks. According to the terms and conditions of PSIAs, depositors are entitled to receive a share of the bank's profits, but also obliged to bear all potential losses pertaining to their investment in the bank. This profit-sharing principle is core to Islamic finance, according to which investors and entrepreneurs must share the risks and rewards of a given venture. As PSIAs are loss absorbing, Standard & Poor's Ratings Services' classic credit ratings are not applicable to this class of instruments. We have decided, however, that our stability ratings are applicable and could provide PSIA depositors with a useful opinion about these instruments.

Stability ratings represent Standard & Poor's opinion about the expected stability of cash flow distributable to PSIA holders of an Islamic financial institution (IFI). By stability, we specifically mean the relative sustainability and variability of distributable cash flow, which underpins cash distributions. Stability ratings are neither opinions about an IFI's overall creditworthiness or profitability; nor recommendations to buy, sell, or hold a particular PSIA. Furthermore, they do not comment on the suitability of any investment for a given investor. Investors may find that stability ratings help them understand and compare the expected volatility of the yield served on PSIAs of different banks, particularly as stability ratings are subject more to changes in the characteristics of the institution than to the ebb and flow of market valuations or sentiments.

Our Stability Ratings And How They Apply To IFIs Offering PSIAs

PSIAs cannot be rated with our classic credit ratings, which indicate probability of default. Absence of a positive return on a PSIA, or depletion of its principal would not be deemed default events per se, except in the case of negligence or misconduct, because these instruments should absorb the losses related to the assets they have financed. For details about how PSIAs work in theory and practice, refer to "Standard & Poor's Looks at Features of Islamic Banks' Unique Funding Instruments" (published June 14, 2005, on RatingsDirect).

Since publishing that report, Standard & Poor's has recognized the need to develop a specific ratings methodology tailored to IFIs offering PSIAs. We came to the conclusion that our existing stability ratings, used since 1999 to rate income funds in Canada (see "Standard & Poor's Canadian Stability Ratings Criteria Update," published June 13, 2005, on RatingsDirect), are applicable to IFIs that offer PSIAs, with only a few adjustments. Under a profit-sharing agreement, PSIA holders agree--for a given period--to share in the profits (or losses) extracted by the bank from a pool of assets. These are then called unrestricted PSIAs, as it is the bank's responsibility to define and manage these assets on its own balance sheet. Investments related to restricted PSIAs, on the other hand, are selected by the investor, and thus resemble more closely assets under management, and are off the bank's balance sheet. Standard & Poor's will provide IFIs with stability ratings, which will only pertain to their unrestricted PSIAs.

Definition of stability ratings

A stability rating is expressed through two key components:

- A rating, which represents our current opinion about the prospective relative stability of

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cash flow distributable to PSIA holders based on its sustainability and variability; and

• An outlook, which expresses our opinion about the trend for the stability rating over a one- to three-year horizon: stable, negative, positive, or developing. StabilityWatch indicates a special surveillance period.

Stability ratings range from 'SR-1' to 'SR-7'. We assign ratings of 'SR-1' to IFIs that we believe have the highest level of expected stability of distributable cash flow. Conversely, IFIs rated 'SR-7' have, in our opinion, the lowest degree of expected stability.

Outlooks and StabilityWatch focus on scenarios that could lead to a change in stability ratings, because Standard & Poor's recognizes that future yields on PSIAs depend on many factors. In general, StabilityWatch sets a special surveillance period during which we monitor one or several events for their effect on the rating (see box).

STABILITY RATINGS SCALE AND DEFINITIONS

Rating Level:

SR-1 An entity rated 'SR-1' has the HIGHEST level of distributable cash flow generation stability.

SR-2 An entity rated 'SR-2' has a VERY HIGH level of distributable cash flow generation stability.

SR-3 An entity rated 'SR-3' has a HIGH level of distributable cash flow generation stability

SR-4 An entity rated 'SR-4' has a MODERATE level of distributable cash flow generation stability.

SR-5 An entity rated 'SR-5' has a MARGINAL level of distributable cash flow generation stability.

SR-6 An entity rated 'SR-6' has a LOW level of distributable cash flow generation stability.

SR-7 An entity rated 'SR-7' has a VERY LOW level of distributable cash flow generation stability.

Outlook
The outlook indicates the expected stability ratings trend over a one-to-three year horizon. The outlook is expressed either as stable, positive, negative, developing, or, in special circumstances, as StabilityWatch, indicating a special surveillance period.

Disclaimer
A stability rating is an opinion and is not a verifiable statement of fact. Stability ratings are based on information provided to Standard & Poor's by an issuer or its agents. Standard & Poor's relies on the issuer, its accountant, counsel, and other experts for the accuracy, completeness, and timeliness of the information submitted to it in connection with a stability rating. Standard & Poor's does not perform an audit in connection with a stability rating and assumes no duty of due diligence or independent verification of any information used in the rating process. Standard & Poor's does not and cannot guarantee the accuracy, completeness, or timeliness of the information relied on in connection with a stability rating or the results obtained from the use of such information. Standard & Poor's may raise, lower, suspend, place on StabilityWatch, or withdraw a stability rating at any time, at Standard & Poor's sole discretion. A stability rating is neither a market rating, nor a recommendation to buy, hold, or sell any security.

Stability rating criteria overview

A stability rating incorporates analyses of three aspects of the issuer: structure and governance; business risk profile; and financial risk profile, which includes an examination of the sustainability and variability of distributable cash flow.

Sustainability has a direct relationship, and variability an inverse relationship, with the stability rating level. Sustainability reflects the likelihood that an IFI will remain in existence and continue to generate cash flows to be distributed to PSIA holders. The sustainability assessment draws heavily on our business risk assessment of the institution and some components of our financial risk assessment. For example, an IFI with a predictable and solid business risk profile and a modest-to-average financial risk position is likely to merit a relatively strong sustainability assessment. Sustainability also incorporates conclusions from our structure and governance analysis.

Variability reflects the level, trend, and patterns of distributable cash flow generation, relying heavily on the distributable cash flow and distribution components of our financial risk profile assessment. Variability considers, among other factors, the volatility, trend, and likelihood of a material drop and magnitude of potential decreases in distributable cash flow generation, including in a worst-case scenario. We are likely to give a relatively strong variability score when PSIA returns exhibit minimal volatility and a stable or positive trend. Although we base the variability assessment largely on quantitative measures (in particular the track record of income distributable and distributed to PSIA holders across cycles), qualitative factors such as our evaluation of management's strategy play a role. Growth of or a positive trend in distributable cash flow generation may offset volatility, leading to an assessment of low variability.

Our Methodology For Assigning Stability Ratings

Stability ratings have a robust analytical framework that is divided into several categories, and proceeds in stages to ensure that Standard & Poor's considers the relevant structural, qualitative, and quantitative issues. The stability rating depends on the assigned sustainability and variability scores, which in turn comprise an analysis of the issuer's structure and governance, business profile, and financial profile.

With this analysis, we assess the sustainability and variability of distributable cash flow to be paid to PSIA holders to form our stability rating opinion. However, there is no simple mechanical formula for combining sustainability and variability scores to arrive at a final stability rating, which is ultimately an opinion and captures nuances beyond specific scores.

In assigning stability ratings, we make no distinctions among PSIAs based on their profit-sharing formulas or maturities.

Structure and governance analysis

We analyze the structure and governance of an IFI to determine weaknesses and vulnerabilities that could prevent it from generating and delivering distributable cash flow. Although Islamic banks are organized and managed in many different ways, Standard & Poor's neither views any one structure as nominally good or bad, nor promotes a single correct structure for all financial institutions, Islamic or not.

Structure and governance analysis is carried out on a case-by-base basis. It also tends to be a general qualitative assessment, which focuses on the quality of management, application of policies and procedures, and management accountability. It takes into consideration universal qualities such as the corporate culture, governance, transparency, and other factors that are specific to an Islamic bank.

Business risk profile analysis

Stability ratings also take into account the business risk profile of the bank. We will analyze a set of factors that determine a company's ability to achieve success and avoid pitfalls in its business. Accordingly, Standard & Poor's business profile analysis for stability ratings draws on our classic credit rating approach, which includes an examination of an entity's:

- Industry characteristics,
- Competitive position;
- Diversification; and
- Strategy.

The business profile analysis begins with a general overview of the IFI's prospects within its industry and competitive and regulatory factors affecting this industry. We factor in impacts of business cycles, whether industry or economic, into the assessment. Given limitations that industry risk characteristics pose, we determine the ultimate business profile for each IFI based on such competitive dynamics as market share, pricing power, and diversification. In addition, we assess the management team's role in determining and affecting operational success, as well as its track record.

The business risk profile analysis provides important input for evaluating the sustainability of distributable cash flow generation. We believe that the business risk profile also affects risk tolerance, as a solid business position implies greater potential staying power. In addition, we consider that a clear understanding of an IFI's revenue and cost cycles is critical to understanding variability.

Financial profile analysis

We base our financial profile assessment mainly on quantitative measures, particularly financial ratios, but we also take into account qualitative components. To calculate financial ratios used in determining stability ratings, Standard & Poor's makes its customary credit rating adjustments to financial statements, such as the inclusion of off-balance-sheet items to facilitate comparability among peers, whether they are Islamic or not. The financial risk evaluation includes an analysis of:

- Accounting and financial policy, including distribution policy;
- Cash flow adequacy and distributable cash flow;
- Asset quality;
- Profitability; and
- Liquidity, financial flexibility, and the funding mix.

Surveillance And Rating Changes

Our surveillance of stability ratings is an ongoing process. This includes an annual meeting with the institution's management and a review of stability ratings at least once a year by a Standard & Poor's rating committee. We also expect to receive quarterly a set of financial information, including audited or at least reviewed financial accounts, as well as any relevant management information pertaining to PSIAs--especially all data regarding profit sharing, and actual as well as expected returns payable to holders of PSIAs.

Stability rating actions will be linked to changes in the characteristics of their primary building blocks: structure and governance, and business and financial profiles. Moreover, stability rating actions consider the degree to which an eventuality had already been incorporated into the analytical process. In other words, an event could have varying degrees of consequences, depending on the extent to which we already incorporated its implications in the existing stability rating. An event can have four different outcomes, some of which may occur simultaneously:

- No change in the outlook or level of the stability rating. This could indicate an event that is already fully incorporated in the stability rating or not significant enough to affect the IFI's profile, or one that alters Standard & Poor's view of the stability rating opinion, but not sufficiently to warrant change.
- The outlook on the rating is revised, including placement on StabilityWatch. Outlook revisions indicate a directional change in stability ratings, and generally state the conditions under which a stability rating action could take place.
- The stability rating is raised or lowered. A change in a stability rating generally reflects a major shift in the sustainability and variability of PSIA returns, and therefore of the fundamental risk profile attached to them.

It is worthwhile to note that stability ratings are not just a snapshot of the current profile of PSIAs, but rather our opinion about how they may perform throughout the ups and downs of business and industry cycles. Our stability ratings in general can withstand normal cyclical pressures. The actual pattern and longevity of any given cycle and its potential long-term effects are nevertheless challenging to predict with a high degree of precision. We would revise a stability rating if the business or financial profile of the bank, and therefore the sustainability and variability of its distributable cash flow generation, is permanently altered.

The stability rating scale includes seven rating categories that have no notches (indicated by the designations '+' or '-'). For that reason, we expect that stability ratings will undergo fewer rating actions than our classic credit ratings (which have three notches for categories 'AA' through 'CCC').

The sustainability component of stability ratings is based on fundamental, structural factors, which are also important factors driving credit ratings. For that reason, we expect the sustainability assessment to correlate materially with our credit ratings.

In contrast, the variability component of stability ratings largely reflects cyclical factors, which affects the business profiles of IFIs less than their short- to medium-term financial profiles. Cyclicality would need to be sufficiently ample on the upside or downside, however, to by itself trigger an upgrade or a downgrade of a stability rating.

A New Service By Standard & Poor's

The application of stability ratings to IFIs is a new service Standard & Poor's is offering to Islamic banks. We will endeavor to ensure that our approach to stability ratings is well known and understood, and we welcome comments from market participants about our initiative. We remain committed to refining and tailoring our stability ratings criteria and methodology to changes and innovation in the marketplace.

As fundamental analysis of the creditworthiness of a bank issuing PSIAs is an essential part of our assessment of stability, an IFI needs an issuer credit rating (ICR) in order to obtain a stability rating. Although we can assign credit ratings without assigning stability ratings, an ICR on a bank is a necessary prerequisite for a stability rating.

World's Islamic Finance Industry To Get A Boost From U.K.'s Development As A Major Marketplace

Competition is heating up among the world's financial centers to attract Islamic issuers and investors. So far, Dubai, Kuala Lumpur, Bahrain, and, to a lesser extent, Riyadh and Singapore, are all well placed to capture part of the booming Islamic finance industry. The latest entrant is London, the only financial center actively involved in Sharia-compliant market intermediation that is not in a Muslim country. London, as a financial center, has a number of competitive advantages compared with its emerging-market counterparts. Among those are:

- Large size and international reach;
- Deep, efficient markets, where investors can switch from one asset class to another (including in and out of sukuk);
- Liquidity in the secondary market; and
- Tremendous human resources and expertise (including research, analysis, operations, and structuring capabilities).

In addition, the legal environment is robust. The tax regime applicable to sukuk coupons will make them deductible--no longer viewing them as rental payments but equivalent to interest. Announced March 21, 2007, among other initiatives pertaining to Islamic finance, this sukuk-friendly amendment to tax law in the U.K. stands to make London more attractive for issuing and trading sukuk, although Dubai has been so far the most active trading center for sukuk notes. The largest sukuk to date were those issued by Dubai-based Nakheel Group (not rated) for $3.52 billion early in the first quarter of 2007. These notes were listed in both Dubai and London.

The overall size of the sukuk market worldwide is estimated at nearly $70 billion, including issuance from Malaysia, Pakistan, and, of course, the Middle East. However, the bulk of sukuk are over-the-counter instruments. Listed sukuk account for only 20%-25% of outstanding sukuk issued worldwide, that is, $10-$15 billion so far. There are more sukuk listed in Dubai than anywhere else, but the secondary market is virtually nonexistent. Second is London, where the secondary market for sukuk totaled less than $5 billion at March 21, 2007. Among listed sukuk, Standard & Poor's Ratings Services rates close to $6 billion or roughly 50% of sukuk outstanding that is listed globally (see the appendix for a list). New sukuk issuance is expected to accelerate, and could reach $20-$25 billion in the next five years, according to the most reasonable forecasts.

We believe that the global Islamic financial industry will benefit from the U.K.'s development as an attractive marketplace for Sharia-compliant financing and investment instruments--on both the wholesale and retail side. We estimate that up to 300,000 retail customers in the U.K. would be ready customers for Sharia-compliant banking services. The establishment of these services in the U.K. would extend the reach of the Islamic financial model--so far still concentrated in a few countries in the Middle East and Muslim Asia. As for wholesale banking, London has the capacity to become a hub for Sharia-compliant financial flows that seek recycling in Europe. For example, Islamic investment banks, like the Bahrain-based Arcapita Bank B.S.C. (BBB/Stable/A-2) and Gulf Finance House (BBB-/Stable/A-3), both

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have offices in London where vast amounts of liquidity from the Gulf meet attractive Sharia-compliant asset classes packaged in private equity, real estate, and infrastructure funds domiciled in the more mature and stable European economies.

U.K. Aims To Become Key Player In Sukuk, While London Sets Sights Even Broader

The U.K. intends to become a key player in market intermediation for sukuk. Competition from Western financial centers is low, as limited appetite for Islamic finance is coming from New York, more interested in facilitating the trading of Sharia-compliant stocks, especially through the Dow Jones Islamic Index, and, more recently, through the newly created family of Standard & Poor's Sharia indices. London, on the contrary, has a wider approach to Islamic finance, encompassing a broader range of financial instruments and asset classes. For example, the Financial Services Authority (FSA) has recently licensed the European Islamic Investment Bank (not rated), a wholesale financial institution created expressly to recycle the massive amounts of institutional and private liquidity in the Gulf into Sharia-compliant asset classes originated in mature, stable, and transparent Western markets.

The FSA has taken on an Islamic retail strategy in keeping with its mission that aims for inclusion. This principle aims at combating financial exclusion, that is, the incapacity or unwillingness of households to access banking services because of distance, poverty, or religion. Some U.K. citizens do not actively deal with banks simply because banking in the U.K. is based on interest, called "riba" in Arabic, considered unlawful according to Sharia, or Islamic law. To counter Muslim customers from being excluded from the banking market because of their beliefs, the FSA has given its green light to established conventional banks to offer Sharia-compliant services. HSBC, through its Amanah brand, and Lloyds TSB already offer Islamic banking services. The FSA has also recently licensed a full-fledged Islamic financial institution, the Islamic Bank of Britain (not rated), to serve the U.K. retail market with Sharia-compliant products. For Sharia-compliant services to become more comprehensive in the U.K., the country needs to offer takaful (or Islamic mutual insurance). Licensing a takaful company or allowing conventional insurers to offer takaful products could be the next step in the U.K.'s strategy to further enhance its position as a leading Islamic financial center.

The U.K. itself might be interested in issuing sukuk notes. Such issuance would be of high interest for investors who adhere to or favor Islamic finance. If the country did so, its issuance would be the second to carry an 'AAA' rating, after sukuk issued by the Islamic Development Bank in 2005 for $1 billion. In addition, the U.K. would be the third sovereign outside the Middle East to issue Sharia-compliant paper, after Malaysia in 2002 through a $600 million structure called Malaysia Global Sukuk Inc. (A-). Japan (sovereign credit rating AAA/Stable/A-1+) has also expressed its intention to tap liquidity in the Gulf through the issuance of Sharia-compliant notes. The German State of Saxony-Anhalt has also issued sukuk, through a vehicle called Stichting Sachsen-Anhalt Trust (AA-) for €100 million in 2004.

Assessing The Risks Of Corporate Sukuk

Rated sukuk are expanding to the corporate sector from their traditional base in banking and sovereigns. Although corporate sukuk are as yet few in number, their popularity looks set to grow as the capital markets in Muslim countries develop and corporate borrowers seek a Sharia-compliant alternative to conventional debt. Sukuk present specific credit risks, however, particularly with regard to delays in scheduled payments, events of default, asset protection, structural issues, and reporting standards. Here, Standard & Poor's Ratings Services outlines some of its key analytical findings in assessing the risks of corporate sukuk.

Issuer And Investor Demand Fuels Sukuk Market Growth And Evolution

The recent surge in sukuk issuance highlights both issuers' and investors' growing interest in Islamic finance. Demand is likely to be met in the Gulf Cooperation Council region, for instance, where there are signs that issuers are increasingly turning to sukuk to raise funds in a context of rapid economic growth. Listed sukuk on the Dubai International Financial Exchange alone amounted to about $16.1 billion at year-end 2007, up from $7.6 billion in 2006. This increase was dominated by three major sukuk issues (see table 1).

Table 1: **LEADING SUKUK ISSUES ON THE DUBAI INTERNATIONAL FINANCIAL EXCHANGE**

Issuer	*Amount*	*Issue Rating*
JAFZ Sukuk Ltd.	AED7.50 billion (about $2 billion)	A+
DP World Sukuk Ltd.	$1.50 billion	A+
Dubai Sukuk Centre Ltd.	$1.25 billion	A+

AED--UAE dirham.

In the corporate realm, there are currently two publicly rated sukuk: JAFZ Sukuk Ltd.'s (A+/Stable/A-1) UAE dirham 7.5 billion issue and Golden Belt 1 B.S.C.'s ('BBB+' debt rating) $650 million issue.

From an issuer's perspective, there appears to be a pricing gap--albeit small and narrowing--between sukuk and conventional debt instruments. There are two key reasons for this. The first relates to issuance costs, with sukuk requiring somewhat more complex legal structures and consequently entailing higher advisory fees. The second is that investors may demand higher rates of return from sukuk to compensate for their relatively illiquid nature, their smaller market size, and the lack of proven legal and bankruptcy systems in issuers' jurisdictions.

Past experience with debt instruments such as asset-backed securities, together with current market indicators, suggests that innovation and market demand for sukuk will continue to the extent that they evolve into a more commoditized asset class. Furthermore, financial institutions will compete to capture this market segment and eventually narrow the pricing gap between sukuk and conventional instruments.

Corporate Sukuk-Specific Features: Risks And Mitigants

Standard & Poor's does not comment on an instrument's Sharia compliance. We apply a unified cross-practice approach to our assessment of sukuk, which takes into account credit enhancement mechanisms, as outlined in "Standard & Poor's Approach To Rating Sukuk" (published Sept. 17, 2007, on RatingsDirect).

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Nevertheless, we believe the following issues should be brought to the attention of investors to clarify the key risks and mitigants involved in corporate sukuk structures.

Delayed payments and events of default

As Sharia prohibits the use of debt and interest-bearing instruments, sukuk technically may appear more like equity. They actually share more similarities with unsecured debt, however. For example, a number of sukuk reviewed by Standard & Poor's offer periodic payments to sukuk holders in the form of returns benchmarked against LIBOR. That said, the promptness of these payments is not strictly administered because Sharia prohibits the application of delayed interest or penalties.

To avoid practical and accounting uncertainties regarding the nature of the payment obligation, and to ensure that issuers meet their debt service schedule, sukuk can be structured to include payments to charity that fall due when periodic payments are delayed. Nevertheless, although this provides an incentive for the issuing entity to pay on time, it does not compensate investors for the delay. Other protection measures allow sukuk holders to declare an "event of dissolution" when scheduled payments are delayed. The declaration entitles sukuk holders to dissolve the trust and receive a distribution of their share of the trust and its assets (in conventional terms, to recall their principal).

In our experience, repayment of initial funds invested (that is, principal) normally takes the form of a stand-alone preset sale or purchase undertaking, or a call or put option whereby sukuk holders have the right to reclaim either the use of the sukuk-allocated assets or the value of the assets themselves on termination of the sukuk, or on an event of dissolution. However, as is also the case for unsecured debt, this mechanism neither guarantees the full recovery of initial funds invested nor gives sukuk holders the right to claim any shortfall from the issuer if the latter is incapable of paying back the full amount of principal.

One way to address this risk is through the use of guarantees. In the JAFZ Sukuk transaction, an external guarantee was used to support the sukuk structure. The sukuk took the form of partnership in a trust between sukuk investors through JAFZ Sukuk and Jebel Ali Free Zone (FZE) (JAFZ FZE; A+/Stable/A-1). There was no direct claim held by sukuk investors over JAFZ FZE's assets or contributions to the trust, as outlined in the sukuk terms and conditions. Sukuk holders benefited from an implicit guarantee, however, under which JAFZ FZE would cover any shortfalls in payments due to sukuk holders. This mechanism put the sukuk within the "full credit enhancement" category of Standard & Poor's sukuk rating approach, which--in combination with the lack of any priority liabilities--meant that the issue rating could be equalized with that on the guarantor, JAFZ FZE.

Asset protection and structural seniority/subordination

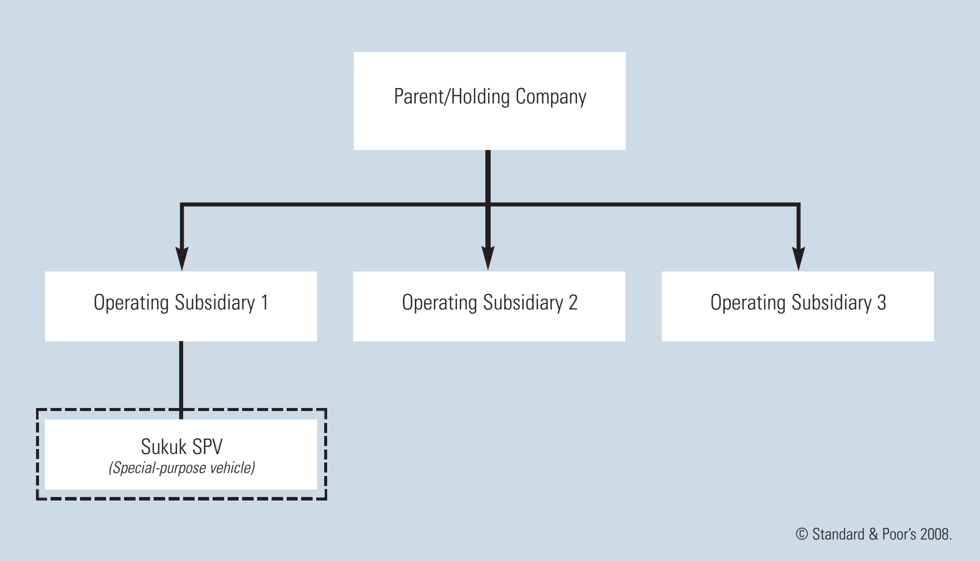
The Sharia requirement that investors fund operating assets, coupled with the equity-like nature of their investment, means that sukuk holders may expect to acquire indirect legal ownership in the allocated sukuk assets. Sukuk structures witnessed so far, however, have been mostly asset based rather than asset backed. This does not offer direct legal claim over the allocated sukuk assets, thereby resembling unsecured lending.

A case in point is the sukuk issued by Saad Trading, Contracting and Financial Services Co. (STCFSC; BBB+/Negative/A-2) through its special-purpose vehicle (SPV) Golden Belt 1 B.S.C. Within the sukuk's structure, the assets are managed by STCFSC, but owned at all times by STCFSC's chairman and major shareholder.

The risk of having no direct legal claim over operating assets may be partially mitigated by enhancement through external guarantees, as for JAFZ Sukuk, or by structural seniority in certain corporate holding structures. Given that a number of obligors hold conventional debt on their balance sheets, sukuk are most commonly issued through SPVs or trusts at the

operating subsidiary level (see chart). The trusts or SPVs isolate the allocated operating assets, together with the sukuk obligations, to avoid the coexistence of conventional debt alongside the sukuk operations, which is prohibited by Sharia.

SUKUK POSITIONING WITHIN ORGANIZATION STRUCTURES



SPVs could benefit sukuk holders if their positioning offers structural seniority over debt held at the parent company level. Sukuk are normally closer to the operating assets, which facilitates the liquidation of assets even if the legal title of the operating assets is not transferred to the SPV or trust. As a result, this positioning may have a negative effect on unsecured debt issues at the parent level.

Accounting standards and the treatment of sukuk

International accounting standards offer some leeway under which sukuk can be classified as debt or equity, with their outflows following accordingly. The classification of a particular sukuk is readily determined from an issuer's balance sheet. If the sukuk is treated as debt, periodic payments will be classified as conventional interest payments as part of financing costs. If the sukuk is treated as equity, however, periodic payments can be reported as dividends and appear directly in the statement of changes in equity without passing through the income statement. This makes calculating interest coverage ratios more challenging. Nevertheless, it is essential to ensure that ratio calculations fully capture an issuer's financial obligations for comparability with other conventional debt issuers. We adjust our calculation to take into account the treatment of sukuk remuneration, thereby ensuring that we capture all the necessary information in assessing the creditworthiness of an issuer.

The Key Sharia Principles Governing Sukuk

As an emerging class of Sharia-compliant securities, sukuk can range from equity-like instruments with an outright ownership interest in the issuer to asset-backed and asset-based securities. Generally, the term refers to bond-like obligations, the majority of which are unsecured.

Restrictions within Sharia prohibit the use of most conventional debt by Islamic borrowers. The key constraint relates to the definition of money as a means of exchange or measure of value and not an income-generating asset in itself. Sharia emphasizes the equitable sharing of risks and rewards by the parties to a transaction, with the accrual of interest through money-lending (riba) synonymous to usury and therefore forbidden. Other

restrictions relate to aspects such as the activity being funded: alcohol- and gambling-related transactions, for example, are prohibited.

The funding of existing (as opposed to speculative) ventures or assets consistent with Sharia and the sharing of risks and rewards are two of the key principles differentiating sukuk from conventional debt. Such concepts dictate the use of ijara (lease) and musharaka (partnership) structures, among others, that can be used in sukuk issues. Ijara sukuk involve the lease of assets from a lessor to a lessee, with the lessor holding the previously acquired title to the assets. They form the basis of periodic rental payments to the lessor, as owner of the asset. In practice, ijara sukuk take the form of sale-and-leaseback transactions, with fixed or variable returns. Musharaka structures address risk-sharing through the partnership-like allocation of risks and rewards. Typically, an SPV or trust is created, to which sukuk holders contribute capital. The issuer, meanwhile, provides operational assets and management. As a whole, the structure allows the sharing of profits and losses generated by the management of the enterprise at predetermined distribution rates and schedules.

Jebel Ali Free Zone (FZE) Rated 'A+/A-1'; Outlook Stable

Rationale

On Nov. 8, 2007, Standard & Poor's Ratings Services assigned its 'A+' long-term and 'A-1' short-term corporate credit ratings to Dubai-based free zone Jebel Ali Free Zone FZE (JAFZ). The outlook is stable.

At the same time, 'A+' issue ratings were assigned to a proposed U.S. dollar MTN program issued by the company and a proposed U.S. dollar issue of sukuk al-musharaka trust certificates to be issued by a special purpose vehicle known as JAFZ Sukuk Ltd., which has also been assigned 'A+' long-term and 'A-1' short-term corporate credit ratings. The outlook is also stable.

The ratings on JAFZ principally reflect our expectation of extraordinary and timely sovereign support based on the company's indirect ownership by the government of Dubai, through Dubai World Corp. (a holding company within the group structure). They also reflect its important role in diversifying the emirate's revenues away from oil and capturing international trade flows. JAFZ is instrumental in maintaining Dubai's position as the pre-eminent logistic and trade hub in the Gulf Cooperation Council region. JAFZ's standalone credit risk profile is supported by stable lease income generated by its land and facilities, as well as concession fees received for licensing and registration. This is offset by an aggressive financial profile, high expected investment levels, and minimal business and geographical diversification.

The ratings on JAFZ are mainly supported by the strong, ongoing backing of the government of Dubai. The government leases land at very low cost to JAFZ to continue to build the physical infrastructure for the free zone, and has facilitated the provision of the necessary accompanying services. JAFZ manages the zone's revenue-generating operations, which can broadly be subdivided into leasing and related services. Accordingly, JAFZ, in combination with the Jebel Ali port and Dubai World Central International Airport (currently under construction), is an integrated vehicle through which Dubai positions itself as a regional and world trade hub. JAFZ's debt carries no explicit government guarantee. The law governing JAFZ states that the government is not liable for obligations arising from the company's activities. However, the strategic and symbolic importance and high public profile of JAFZ, coupled with its operational proximity to the ruler of Dubai and the emirate's financial strength, lead Standard & Poor's to conclude that the government could and would intervene if JAFZ, and ultimately Dubai World Corp., were to face financial difficulties.

JAFZ's financial profile carried little financial leverage until recently. However, a large capital expenditure program (about UAE Dirham (AED) 8 billion to be spent until 2011) will lead to a gradual build up of debt. JAFZ's debt-to-EBITDA ratio is expected to peak at about 8x-9x in the period from 2007 to 2009, but is expected to gradually fall in subsequent years. JAFZ's leverage is expected to remain high, however, in the range of 6x-8x, which will restrict the standalone rating assessment. As a result of the planned increase in debt levels and the time lag before these investments start generating cash flows, EBITDA interest coverage will be very weak initially, at about 1.5x-2.0x. This should stabilize at about 2x for the current standalone assessment.

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Short-term credit factors

The short-term credit rating is 'A-1'. JAFZ has a $250 million (about AED920 million) intercompany revolving credit facility with Port and Free Zone World FZE (a holding company within the group structure), which is to be used for liquidity purposes and should cover working capital fluctuations. In addition, JAFZ is expected to have access to liquidity through its ultimate parent--Dubai World Corp.--if needed. JAFZ's debt is expected to consist primarily of long-term capital market issues and Islamic finance products to be issued by the end of 2007. JAFZ currently intends to spend up to AED8 billion on expansion projects until 2011. The project plan includes:

- Two office buildings to be completed in 2008;
- A large facility comprising a convention center, hotels and other accommodation, and office buildings, which is to be completed in 2010;
- Additional light industrial units with showrooms;
- On-site residential properties, housing more than 18,500 people; and
- Continual maintenance and phased renovation of existing units.

There is projected need for additional complimentary products and facilities, which is expected to lead to sustained high capital expenditure levels in subsequent years, on top of what is currently projected by the company. Accordingly, JAFZ is expected to remain cash flow negative and reliant on external debt funding (combined with further equity injections by Dubai World Corp., if needed) over the long term.

Recovery analysis

Standard & Poor's has assigned 'A+' senior unsecured debt ratings to a proposed issue of sukuk al-musharaka trust certificates by JAFZ Sukuk Ltd. and a proposed global MTN program of JAFZ itself. The amounts of the sukuk issue and the MTN program have yet to be determined. The assigned ratings are equalized with the long-term rating on JAFZ. This reflects a lack of contractually senior liabilities and structural subordination issues given that JAFZ is the actual operating company and has no operating subsidiaries. All of JAFZ's future lending is expected to be on an unsecured basis.

Although sukuk investors have no direct claim over JAFZ's assets or its contributions to the musharaka trust, they benefit from an implicit guarantee whereby JAFZ will cover any shortfalls in payments due to them. Under Standard & Poor's sukuk rating methodology, the sukuk qualifies for full credit enhancement, which entails equalizing the issue rating with that on JAFZ. As the musharaka trust, and ultimately the sukuk noteholders, have no senior claim on the cash flow generated by the land assets dedicated to the trust, the sukuk issue ranks equal to that of other senior unsecured debt issued by JAFZ.

The ratings are dependent on receipt of satisfactory documentation. They are not final and Standard & Poor's reserves the right to withdraw or change them. Final ratings will be assigned on receipt and satisfactory review of all final transaction documentation, including legal opinions.

Outlook

The stable outlook reflects the likelihood of ongoing support from the government of Dubai. As the stand-alone creditworthiness of JAFZ is in our view lower than that of the government, any indication that the government's commitment to JAFZ is weakening would result in a lower credit rating.

Golden Belt 1 B.S.C. Proposed Sukuk Assigned Preliminary 'BBB+' Sr Unsecured Debt Rating

Rationale

On April 18, 2007, Standard & Poor's Ratings Services assigned its preliminary 'BBB+' senior unsecured debt rating to the proposed U.S. dollar-denominated floating-rate sukuk ("sukuk al Manafa'a"; trust certificates) to be issued by Bahrain-based Golden Belt 1 B.S.C., (trust). The amount of the issue is yet to be determined.

These are not final ratings and Standard & Poor's reserves the right to withdraw or change its ratings. Final ratings will be issued on receipt and satisfactory review of all final transaction documentation, including legal opinions.

The trust is a special-purpose vehicle (SPV) incorporated in accordance with the laws of the Kingdom in Bahrain.

Under the transaction, the trust will issue rated trust certificates, the proceeds of which will allow the trust to finance an initial head lease payment to Maan Al-Sanea for leasing land parcels mainly located in Al-Khobar, Saudi-Arabia. The proceeds will ultimately be used for general funding purposes of Saad Trading, Contracting and Financial Services Co. (STCFSC; BBB+/Stable/A-2), which has agreed to enter into a sub-lease agreement with the trust. The transaction allows STCFSC to raise funds on terms compliant with Sharia (Islamic law).

The preliminary 'BBB+' rating on the trust's floating rate trust certificates reflects Standard & Poor's assessment that the rating on the sukuk can be equalized with the long-term rating on STCFSC for the following reasons:

- All the trust claims vis-à-vis STCFSC, including the lease rentals
- payable by STCFSC as sub-lessee to the trust under the sub-lease
- agreement, which will fund the periodic distribution payments on the
- trust certificates, are unsecured and unconditional obligations of
- STCFSC, and rank pari passu with all other unsecured and unsubordinated
- obligations of STCFSC. The lease rental payments are irrevocable, even
- for total loss of one or more leased premises;
- STCFSC treats this transaction in its own accounts like any other capital
- market debt transaction; and
- The trust's sole objective is to irrevocably undertake to hold and
- administer all rights and obligations under its assets on trust for the
- sole benefit of the certificate holders.

The preliminary rating on the sukuk further reflects its strategic importance to STCFSC-- part of Saudi Arabia-based conglomerate Saad Group (Saad; BBB+/Stable/A-2)--in funding its real estate business strategy. However, in the case of a distress scenario, Standard & Poor's considers that there is no assurance that rental payments or termination could be enforced.

The proceeds will be used for business purposes, including real estate and investments, and partially to restructure current borrowings at STCFSC. There is no structural subordination for the debt, as STCFSC mainly pursues unsecured financing and the sukuk will rank pari-passu to the other liabilities at STCFSC. Financial covenants included in the sub-lease agreement are expected to offer the company substantial headroom.

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Takaful: A New And Viable Insurance Business Model Or Just A Marketing Opportunity?

Cultural and religious reasons are commonly cited for the underdevelopment of insurance markets in the Gulf Cooperation Council (GCC) region. Takaful could be the key to increasing insurance awareness and delivering on customer expectations, capitalizing on the positive economic dynamics of the region.

The opportunities for increased uptake of takaful insurance in the GCC are positive. The considerable economic growth in the region, coupled with a sizable, underinsured population, means that there are substantial prospects for further development of personal lines cover. The ability of the industry to demonstrate the need for and benefits of insurance, as well as to successfully meet customer demands, remains unproven, however.

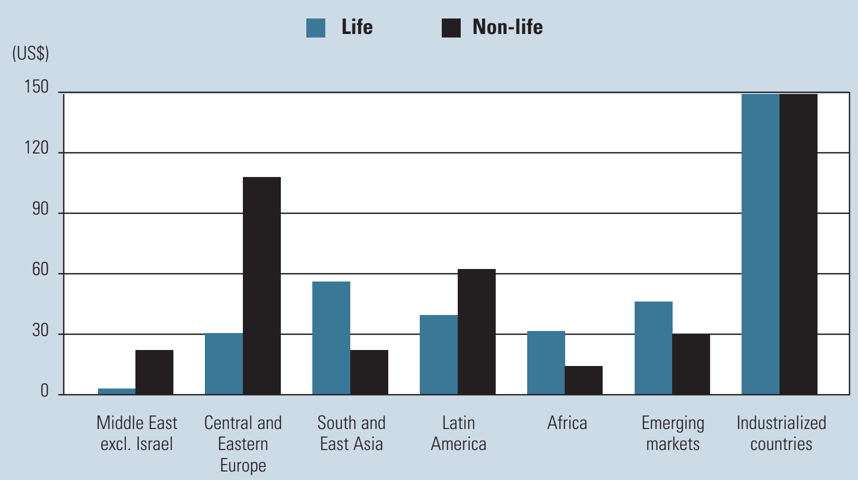
Over time, if the world average insurance premium of $550 per capita is achieved and applied to the Gulf states, the GCC insurance market has a potential size of $20 billion (currently $4.6 billion). Taking as an example Malaysia, where the takaful market is expected to contribute 20% to the overall market in the medium term, the GCC takaful market has the potential to reach $4 billion at the current level of development (currently $170 million). How much actual premium the takaful sector generates and how quickly it will do so remains to be seen, however, and will depend on the industry's ability to deliver on policyholder expectations.

In terms of credit ratings for the takaful sector, Standard & Poor's Ratings Services will apply the same analytical process as for the traditional market, but will also take into account the sector's positive growth dynamics and high execution risk.

GCC Insurance Markets

The insurance markets in the region are recognized as being underdeveloped, as is shown by the relatively low level of insurance penetration relative to Western or even Eastern Europe (see chart).

2005 PREMIUMS PER CAPITA



Source: Swiss Re sigma No. 5/2006. © Standard & Poor's 2007.

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The economic boom in the GCC, driven by high oil prices, has led to substantial infrastructure investments across the region, with the corresponding need to insure these sizable risks. There are a number of established insurers in each of the GCC markets who are able capable of participating on the new risks arising. Certainly, the development of the non-life insurance market in the region is strong, with premium growth of about 10%-15% on average since 2004. The proportion of personal lines insurance cover, however, and in particular life insurance, remains low.

Opportunities For Takaful

Increasing insurance penetration, raising awareness

Takaful is not a new concept. The idea of cooperative risk sharing is the oldest form of insurance. The Grand Council of Islamic Scholars, Maja-al-Fiqh, only approved takaful as a Sharia-acceptable alternative to traditional insurance in 1985, however. The real opportunity for takaful in the longer term is substantial in our view, as it is able to reach the specific segments of the market that traditional insurance has been unable to attract.

Strong growth relative to traditional insurance market

The GCC takaful market is currently growing at about 40% per year, and gross contributions (equivalent to gross premiums written) amounted to nearly US$170 million in 2005 (see table 1).

Table 1: **GROSS CONTRIBUTIONS***

	Takaful			Traditional		
(Mil. US$)	**2005**	**2004**	**Growth (%)**	**2005**	**2004**	**Growth (%)**
Bahrain	21	22	(3)	252	239	5
Kuwait	79	55	44	419	386	9
Oman¶	N.A.	N.A.	N.A.	292	267	9
Qatar	34	25	35	377	279	35
Saudi Arabia§	N.A.	N.A.	N.A.	1,402	1,143	23
United Arab Emirates	33	17	98	1,862	1,575	18
Total GCC	167	119	41	4,604	3,889	18
Malaysia**	353	296	19	7,227	6,453	12

*Standard & Poor's estimates and Swiss Re sigma No. 5/2006. ¶The Sultanate of Oman specifically forbids the use of the takaful name. §We have assumed that the whole of the Saudi market is traditional, even though insurers operate under a cooperative structure and have received exemptions from their Sharia boards for their investment portfolios in order to comply with regulation. **Bank Negara Malaysia and Swiss Re sigma No. 5/2006. N.A.--Not available.

This appears impressive relative to the expansion of the world markets, with average premium growth at 2.5% in 2005 (Swiss Re sigma No. 5/2006). It is, however, important to remember that this is a new segment of the market and growth at this level is not unexpected. At the same time, this growth is not purely driven by the personal lines market--one which we consider to be a natural market for takaful--but to a large extent also by general commercial lines. The main challenge for takaful still remains: to increase awareness of the benefits (social as well as individual) of insurance among retail customers. Still, the future success and sustainability of this pace of development will be dependent on a number of factors that, within personal lines, are just as relevant to the traditional as to the takaful regional markets.

The Success Factors

Product innovation and service quality

Although compulsory lines of business (motor and, in some cases, medical for expatriates) have driven much of the growth in the retail sector across the GCC, personal lines products are far from developed. This is as true of the traditional as of the takaful market. We view the recent announcements by international insurers that they will be entering the family takaful segment as positive, whether this is done as a joint venture with local companies, a greenfield operation, or through a branch.

The takaful market faces some unusual challenges. It has to match the service quality of the traditional insurance market and persuade an uninsured market to use the facilities of the takaful market. But across the Gulf region we are now seeing traditional insurers accept risks into new takaful divisions or subsidiaries of the mainstream company. Although the takaful division is operated as a wholly Sharia-compliant unit, it is fully complementary to the noncompliant business. If this model achieves the three key requirements of meeting Sharia council approval, being accepted by the Islamic community and policyholders, and passing regulatory requirements, the probable benefits of economies of scale to the traditional company will prove a real challenge to the nascent takaful sector. Each of the approaches has its own merits, but Standard & Poor's is unable to comment on their relative Sharia compliance and acceptance in policyholders' eyes.

The role of foreign insurers is also important, as they bring pockets of expertise in designing, for example, life products suited to local customers. This is gradually improving product choice, but the success of the takaful business model will depend on its ability to offer the same choice, range of products, level of cover, cost effectiveness, and, ultimately, quality of policyholder security, as traditional insurers. The challenge for takaful operators in developing family takaful will be to structure the products in such a way as to meet any religious and cultural obligations and still offer comprehensive cover.

In our opinion, it will also be crucial for takaful operators to demonstrate their ability to offer a comparable, if not better, level and quality of service than the traditional market when dealing with retail policyholders. The use of improved technology in automating processes (ease of buying a policy, speed of claims handling) to directly benefit the consumer will also benefit the takaful operators' long-term competitive standing and prospects in the market.

Promotion and distribution capabilities

Even with the best products and service, future development will be constrained without the creation of demand and an increased awareness of the need for insurance. The onus still remains on the takaful operators to emphasize the broad appeal of Islamic insurance. In fact, takaful can be marketed as the "ethical" alternative to insurance contracts due to its rigorous screening of investments. Additionally, in our view, expansion of independent financial adviser networks in all the Gulf states is essential. At the same time, some form of regulation is necessary to ensure adequate training of advisers and quality of advice to protect policyholders. The growth of Islamic finance, and in particular retail Islamic banking solutions including Islamic mortgages and credit cards, is certainly encouraging.

We also see bancassurance as providing the right additional distribution mechanism to reach the right retail customer. In the more established Malaysian takaful market, contributions from bancassurance constitute slightly more than 20% of all takaful contributions, second only to direct marketing (about 45%). In comparison, this distribution channel remains underutilized in the GCC, and generally contributes only a small amount to the overall contributions generated, as there are few bank-owned takaful operators.

Policyholder security, enterprise risk management, and profitability

Many family takaful contracts, and some general takaful contracts, will be more long-term in nature than the policies currently prevailing in the market (such as term life assurance or mortgage protection products). Therefore, the ability of a relatively new takaful operator to service claims and ensure policyholder security over the next 10-20 years is crucial. This is where a strong regulatory environment comes into its own--to protect the policyholder and encourage healthy development of the industry, for both the traditional and the takaful segments. Specifically for takaful, the role of the Sharia board in overseeing the proper management of policyholder funds should help to increase transparency and improve corporate governance. Participants can increasingly benefit from the scrutiny of takaful operators by rating agencies such as Standard & Poor's.

Generally, capitalization is strong given the underwriting risk base, and is expected to remain so for the medium term for both traditional and takaful insurance providers. Few insurers, however, have developed a more comprehensive, holistic approach to capital and risk management, and many appear to face high investment risk in their portfolios. Although traditional insurers currently have more investment opportunities open to them, they don't always take them. In fact, a lot of the regional companies have a high percentage of equities in their investment portfolio. In the recent market corrections, companies have faced substantial volatility in earnings and shareholders' funds, and have experienced reduced investment liquidity. There has been a high level of liquidity for policyholders' funds, however, as cash deposits typically generously cover technical reserves. For takaful providers, as Islamic financial markets are developing rapidly, we expect that investment concentration risk, subject to management asset allocation choice, will be diversifiable in the medium term. Nevertheless, quantification of the risks undertaken throughout all operations, whether investments or underwriting, still requires development to ensure controlled earnings over time.

To date, takaful has not necessarily been the more profitable approach, as the general concept of mutualization of risks is applied. Average combined ratios have been higher than for traditional, regional peers (see table 2).

Table 2: **PERFORMANCE COMPARISON**

	Takaful*		Traditional¶	
Averages (%)	**2005**	**2004**	**2005**	**2004**
Net expense ratio	136.3	61.4	12.3	12.5
Net loss ratio	74.1	73.7	66.7	65.8
Net combined ratio	210.4	135.1	79	78.3
ROE	25.1	N.A.	17.2	14.5
Adjusted shareholders' funds (mil. US$)	105	74.2	224.8	153.1

**Standard & Poor's estimates. ¶Extracted from Standard & Poor's ClassicDirect database. N.A.--Not available.*

Although the essence of takaful is cooperative risk sharing and community well being, rather than profit optimization, continued underwriting profitability will be important in order to invest in future growth. At the same time, takaful operators are currently suffering from a lack of economies of scale and an inability to more effectively diversify their risks. Hence, the management fees and contributions charged appear high in light of the true costs incurred by the operator. Although it is up to the individual Sharia boards to look more closely at this, we expect fees to decline and premiums charged to be more reflective of the level of cover provided as competition and scale in the takaful segment increase. The key benefit for

policyholders over time, however, will be the distributable surplus more closely reflecting actual performance.

Appendix: What Defines A Takaful Company And How Does Retakaful Work?

Standard & Poor's insurance ratings criteria are fully applicable to takaful companies (see "Takaful: A New Face For Insurance," published Jan. 31, 2006, on RatingsDirect), although there are a few differences in the operating model. A takaful company manages two separate funds: one for the participants/policyholders and one for the shareholders. The participants pay to the takaful company a fixed management fee ("wakala"), a performance-based fee ("mudharabah"), or a combination of both. In addition, they pay contributions (premiums) to cover potential future claims. In return, the operator manages the various risk pools (such as motor policies and household policies) and pays the claims arising from the accumulated funds.

The operator invests the contributions received from the participants in acceptable assets, yielding a return. The investment management expenses are typically borne by the takaful operator, receiving a share of performance-based investment profits ("mudharabah") in return. In this, the takaful model is similar to the mutual or cooperative insurance model. If, however, there is a shortfall for claims settlement in the accumulated fund (contributions and investment profits), the shareholders are required to provide an interest-free loan ("qard hassan") to cover the deficit. This loan is then repaid by the participants through future contributions. At the same time, if there is a surplus in the participants' fund, this surplus may be distributed to policyholders.

In terms of the governance structure, takaful companies have a Sharia board in addition to the usual board of directors. The role of the Sharia board is to oversee the management of the two funds according to the principles of Islamic law. Among other things, this involves ensuring that invested assets are acceptable in terms of Sharia law and ensuring the equality in treatment of shareholders and policyholders.

Retakaful provides capacity to takaful companies under the same operational model, in the same way that reinsurance provides capacity to insurance companies. Due to low levels of quality capacity historically, however, Sharia boards of direct takaful companies have temporarily allowed the use of traditional reinsurers. The main difference is that takaful companies are not allowed to accept reinsurance commissions, but they can accept the surplus distribution from retakaful companies. As the primary takaful market grows, therefore, we can expect increased retakaful capacity and participation.

Islamic Finance To Expand Slowly But Surely In The Maghreb

For many years Islamic finance was virtually unheard of in the Maghreb. And while Sharia-compliant financial services remained only marginal, no clearly identifiable demand for such products was manifest. Today, the evolution of North Africa's financial landscape is paving the way for the gradual emergence of Islamic finance in the region.

The currently only limited presence of Islamic finance in the Maghreb can largely be explained by the differences in interpretation of Sharia that have existed historically in the Muslim world. A less conservative interpretation of Islamic law in North Africa resulted in Islamic finance being perceived as being less attractive there than in the Gulf region.

Now, as North Africa is increasingly seeking investment to finance its economic development, the Mashreq is emerging as a natural partner. Culturally close, it can provide an already sophisticated Islamic financing offer that corresponds well with the particular needs of the Maghreb.

Standard & Poor's Ratings Services is not offering an opinion regarding the degree of conformity to the principles of Sharia of banking services or products offered by Islamic financial institutions, nor on the differences in interpretation of these principles with respect to the various trends in thinking that exist in the Muslim world. Rather, we consider this to be a matter for the Sharia boards on conformity.

Having said this, an understanding of the underlying principles of Islamic finance allows us to take into consideration the risk factors that relate specifically to these products in our evaluation of the creditworthiness of Islamic institutions. Our coverage of Islamic banks as well as of financial certificates that conform to Sharia (sukuks) has developed strongly during the past two years (see table at the end of this article).

The Limited Presence Of Islamic Finance In The Maghreb Is Linked To Regional Differences In The Interpretation Of Sharia

Wide variations in intepretation of Sharia exist between the different schools of Islamic thought. These differences go some way toward explaining the varying degrees of dynamism pertaining to Islamic finance that can be found in the different subregions of the Muslim world. These divisions, which are cultural and religious rather than purely political, explain in large measure the lack of attractiveness with regard to Islamic finance that prevails in North Africa, where there has been only a low take-up of this type of financing from the population.

The limited development of Islamic finance in the Maghreb can in part be explained by the perception of this banking model that exists in the countries of the region. Islamic finance has for a long time been quite foreign to the region's banking culture and largely imported from the eastern reaches of the Arab world, the Mashreq.

For the most part, North Africa follows a less conservative interpretation of Islamic doctrine--in keeping with a good part of Muslim Asia--compared with the Gulf. In Egypt, for example, the prestigious al-Azhar University has issued a "fatwa" (a formal legal opinion handed down by a Muslim judicial authority) calling on the faithful not to consider interest as "riba" or usury (the first pillar of modern Islamic finance), but to only consider "excessive" or "usurious" interest as illegal from the point of view of Sharia.

Historically, the banking clientele of the Maghreb has never really demonstrated any real reticence regarding the concept of interest; indeed, there exists a vast consensus that tolerates, even values, the transparency of conventional financing based on interest rates. In contrast, a

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large number of religious authorities in the Gulf have underscored the illicit nature of interest applied to bank credits.

It is quite common for Islamic banks to propose financing instruments at higher rates than those offered by their conventional peers. This is perfectly acceptable in the Gulf states where the average credit quality of clients is higher than it is in North Africa. The banking clientele in North Africa seeks more to minimize the costs attached to banking services. In this sense, a North African borrower would generally find it difficult to accept paying for an "ijara" (leasing) service that is more expensive than an equivalent conventional operation for the sole reason that the former conforms to the principles of Sharia and the latter doesn't.

Finally, the speed with which North Africa has opened up to the rest of the world means that banks there have every interest in being modern and aligning themselves with the standards of quality of European or American banks in order to attract the best clients, which is not perceived as compatible with an Islamic banking image.

The political constraints that could hold back the spreading of Islamic finance in the countries of the Maghreb are far from being the most important: the cultural, religious, and microeconomic stakes constitute mechanisms that are equally as powerful in holding up the spreading of Islamic finance in North Africa, in marked contrast with the trail that has been blazed in the Gulf and in Malaysia.

A conservative Islamic bank that wished to safeguard its respect for Sharia could find itself attracting only a mass clientele, more sensitive to religious aspects but also less profitable and more risky, even though this would rule out its simultaneously conveying the image of a bank in line with best management practices and at the forefront of technology. In this sense, an Islamic bank in North Africa would be naturally led to practice spontaneous antiselection, in complete contrast to its Gulf peers, whose average retail clients are far more creditworthy. In this case, it would accumulate bad debts, and would encounter a lot of difficulty in realizing its guarantees in view of its "ethical" character, which went hand in hand with its Islamic status. An Islamic bank would have greater difficulty in recovering its loans to households in default of payment.

The Development Of Islamic Finance In The Maghreb Should Be Gradual

Generally speaking, the gradual development of the economic environment in the Maghreb so far and the caution historically excercised by its business leaders in taking decisions could act as the principal brakes on the future evolution of Islamic banks in the region. In Morocco, the concept of an Islamic bank is for the moment largely absent from the financial practices of major institutions. In Tunisia and Algeria, Islamic finance is limited to two banks: Bank Et-Tamweel Al-Tunisi Al-Saudi and Banque Albaraka d'Algérie, both subsidiaries of the same finanicial conglomerate, Albaraka Banking Group (B.S.C.) (ABG; BBB-/Stable/A-3). ABG is majority held by Saudi investors; the parent entity is domiciled in the Kingdom of Bahrain (A/Stable/A-1).

Local interest in Islamic finance is gathering momentum

The presence of Islamic banks in certain countries of the Maghreb has been accompanied by the gradual development of the opinion of local regulators in its regard. A few years ago, the issue of Islamic finance had been barely touched upon in public debate, and presented an appeal that was at best exotic for regulators and directors of banks already active in the market. Today the subject generates more interest: discussions are being refined, and market players are beginning to see in it an interesting engine of growth from the perspective of gaining market share.

In 2006, following the example of a large number of its peers in the Muslim world, the Central Bank of Morocco (Bank Al-Maghrib) became a shareholder of the International

Financial Services Board (IFSB). Based in Malaysia, this "club" of central banks serves as a transnational regulatory body aiming to harmonize standards of prudential regulation applicable to Islamic banks.

The recent interest expressed by Morocco, Algeria, and Tunisia in Islamic finance comes as no surprise. In fact, Morocco is growing at an annual rate of more than 7% in real terms, generating colossal flows of investment in infrastructure and human capital, at a time when its stragety of setting up a lasting international specialization (notably in terms of offshoring) is being set out in a clearer manner. This implies not so much foreign indirect investment, but real foreign direct investment (FDI), the provenance of which is widening to include financial flows coming from the Gulf.

The Mashreq is emerging as a natural partner

Europe and North America represent longstanding political partners, not only for economic reasons but also for motives of geopolitical influence within an Arab world in the throes of transformation. The insufficiency of these measures, however, in fulfilling the purely economic needs of the countries of the Maghreb has led the latter to approach the Mashreq, which benefits from a lasting supply of surplus liquidity stemming from the manna that is represented by hydrocarbons, whose prices have been maintained at record levels during the past three years.

Tourism, real estate, and infrastructure constitute the three principle asset classes causing investors from the Mashreq to be attracted to the Maghreb. All three sectors are particularly attractive from the point of view of Islamic finance. In fact, the second principle of Islamic finance holds that any financing activity that conforms to the rules of Sharia must be supported by an underlying tangible asset. Hotel facilities, real estate, and infrastructure projects therefore present an inherent conformity with Sharia, and demand emanating from the Maghreb for financing of these sectors fits naturally with Sharia-compliant offers.

Such offers are essentially being issued by a new generation of Islamic banks in the Gulf, specialized not in conventional banking intermediation, but in the business lines of investment banks. Arcapita Bank B.S.C. (BBB/Stable/A-2), Gulf Finance House (BBB-/Stable/A-3), and Unicorn Investment Bank (not rated), all based in Bahrain, are the best representatives of this new generation of financial intermediaries, capturing the capital that institutions and wealthy families are seeking to invest and recycling it in high-yielding industrial, real estate, and infrastructure projects.

The emergence of Islamic investment banks allows a double objective to be met: on the one hand, it guarantees the recycling of liquidity from the Gulf in profitable asset classes that rank as eligible among Sharia-compliant investments, and, on the other hand, it allows the surplus liquidity to be allocated to a cultural area considered to be close, insufficiently exploited economically, and in need of FDI. As a consequence, Islamic finance could drive a significant portion of sustainable financing from the Mashreq to the Maghreb, particularly in the financing of infrastructure, tourism, and real estate projects.

Significant potential exists for development, which should be gradual

The underdevelopment of Islamic finance in the countries of the Maghreb is particularly striking in the domain of individual banking. The proximity between Islamic finance and individual banking is however obvious: it is households first and foremost that are sensitive to religious arguments in matters of finance. In view of the spectacular growth in this line of business in the past three years, notably in Morocco and Tunisia, several Islamic banks in the Gulf that lack geographical diversification would find it interesting to gain a foothold in retail banking in the Maghreb.

In this expansion of the individual banking market, the social and thus political stakes are

important. The local authorities responsible for regulation and supervision of banking systems in the countries concerned will therefore undoubtedly play a role in the opening of their borders to Islamic financial institutions domiciled in the Gulf. In fact, we believe that the development of Islamic finance in the countries of the Maghreb should be very selective, and that the North African regulators will certainly not authorize a massive entry of Islamic competitors into their territories.

It should be pointed out, however, that banking competition within the most financially mature countries of the Maghreb (Morocco and Tunisia) is intensifying, and that, as a consequence, Islamic finance can represent a good means of achieving strategic differentiation beyond the classic strategies of pricing and quality.

The introduction of Islamic finance into the Maghreb will likely be gradual. Bank Al-Maghrib announced on March 20, 2007, that Moroccan banks were authorised to offer banking services that conform to Sharia. At present, this authorization is limited to three products: “ijara” (leasing), “murabaha” (a contract to purchase and resell an underlying good including a mark-up), and “musharaka” (equivalent to a co-ownership financing structure).

In the same way, Tunisia for its part has made a significant advance in terms of Islamic finance by adopting, in February 2007, a law pertaining to the creation of an “international Islamic institution”, in partnership with the Islamic Development Bank, whose authorized capital would amount to $3 billion. The objective of this institution is to contribute, through its Islamic financing activities, to boosting business between the Arab countries of the Maghreb and the Mashreq.

Finally, the existance of public-sector banks that could be privatized in each of the countries of the Maghreb may attract Islamic banks in the Mashreq inclined toward external growth: in Morocco, Crédit Industriel et Hôtelier and Crédit Agricole du Maroc could be put up for sale; in Tunisia, the reference shareholders of Banque Tuniso-Koweitienne will likely change; and in Algeria, it seems that, in addition to Crédit Populaire d’Algérie, other public-sector banks are in a position to be looking for private buyers.

Credit FAQ: An Introduction To Islamic Finance

Islamic finance is emerging in many parts of the world as an alternative financing concept to the conventional orthodoxy of paying interest on borrowings and deposits. An investing approach based on "Sharia" (please see the appendix of Islamic financial terms) or Islamic law, Islamic finance is concentrated in Muslim parts of the world: the Middle East, North Africa, and Southeast Asia. Modern Islamic financing techniques were developed in Muslim parts of Asia, notably Malaysia, but the boom since the mid-1990s has come from the large oil revenues flowing into the Gulf region. Now, the ideas and concepts of Islamic finance are attracting conventional issuers and investors seeking to tap into new investment opportunities.

Frequently Asked Questions

What are the key principles of Islamic finance?

To be considered Sharia-compliant, a financial institution or transaction needs to meet the Koran's strict tenets against usury and uncertainty. Perhaps the best-known principle of Islamic finance is "riba," the ban on charging or paying interest. Sharia doesn't consider money as an asset class because it is not tangible; therefore, it may not earn a return. Instead, Islamic law calls for a means of sharing the profits from a transaction or institution among participants--here, the client and financial institution or instrument. Secondly, Islamic law prohibits uncertainty of payout or gambling, but not risk--as long as it is shared among all parties. No one participant should shoulder an unequal degree of risk. Thirdly, any Sharia-compliant transaction must be backed by a tangible and identifiable asset. Lastly, Islamic finance forbids investment in or dealings with those industries banned under the Koran: notably alcohol and brewing, tobacco, weapons and armaments, or pork-based products.

What types of financial institutions and transactions are involved in Islamic finance?

Islamic financial services are carried out by Islamic banks; conventional banks, through so-called Islamic windows; and Islamic cooperative insurance companies (known as "takaful") and reinsurance companies ("retakaful"). Islamic finance currently mostly offers basic products and services, even note-like securities called "sukuk," but is developing quickly, with some forays into project finance and securitization. It will still be a while before Islamic financial institutions offer the full range of products and services of conventional institutions.

How are Islamic banks different from conventional banks?

The biggest difference between Islamic and conventional banks is that Sharia-compliant institutions do not pay interest on deposit accounts. The attraction for clients, however, is that Islamic banks usually also offer profit-sharing investment accounts (PSIAs) that are bound by a "mudaraba" contract. These PSIAs are a major source of funding for Islamic banks. When rating Islamic financial institutions, we view PSIAs as akin to hybrid capital due to their combination of debt- and equity-like characteristics.

How does Islamic insurance work?

Sharia-compliant insurance companies, known as takaful, operate like conventional mutual or cooperative insurers. A takaful manages two separate funds: one for shareholders and one for policyholders--who Sharia considers as participants in the venture. The participants pay the

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takaful a "wakala" fixed-management fee or a mudaraba profit-sharing fee, or a combination of both, as well as premium-like contributions to cover potential, future claims. In return, the insurer manages the various risk pools (motor policies, homeowners insurance, etc.), and pays claims against the accumulated funds. The takaful invests participants' contributions in Sharia-acceptable assets, yielding a return. The investment management expenses are typically borne by the takaful, which in return shares in the profits with participants. If the accumulated fund runs short and cannot pay claims, shareholders are required to provide an interest-free loan ("qardh hasan") to cover the deficit. This loan is then repaid by participants through future contributions. On the other hand, if the accumulated fund runs a surplus, the excess may be distributed to policyholders.

Retakaful provides capacity to takaful in the same way that conventional reinsurers provide capacity to conventional insurance companies. The main difference is that takaful are not allowed to accept reinsurance commissions, but can accept the surplus distribution from retakaful. Due to persistently low levels of quality capacity in the Islamic marketplace, however, Sharia boards of direct takaful companies have temporarily allowed them to use conventional reinsurers.

What are sukuk?

Sukuk are Sharia-compliant financial instruments that can be compared to conventional notes. Of the many categories of sukuk, the most common in the market and that are rated are "ijara" sukuk, which are backed by leases and often guaranteed by sovereign or regional governments. Because of the predominance of ijara sukuk, these transactions are commonly viewed as the de facto benchmarks in the Islamic marketplace. Ijara sukuk are structured around a specific asset, such as a building, property, or infrastructure facility. The asset itself is sold to a special-purpose entity that then issues the sukuk to fund the asset's purchase price. The special-purpose entity then leases the asset and receives periodic lease payments. At maturity, or in the event of dissolution, the special-purpose entity sells the asset back to the original seller at a predetermined price that includes any outstanding amounts still owed under the terms of the ijara sukuk.

What type of organization issues sukuk?

Most sukuk is issued by sovereigns, corporations, and Islamic financial institutions located in the Gulf or Muslim areas of Southeast Asia. But Islamic finance is not restricted to Muslim issuers or investors. Sukuk has in fact been issued by non-Islamic entities outside these areas. For instance, the German State of Saxony - Anhalt (AA-/Stable/A-1+) issued a ?100 million five-year sukuk that we rated "AA-" in 2004, via its Stichting Sachsen-Anhalt Trust financing subsidiary. Great Britain may become the first Western country to introduce regulation to support sukuk. The U.K. Treasury is writing legislation for introduction in 2007 to recognize sukuk as debt finance, so that issuers can offset payments against their profits when calculating corporate taxes.

Does Standard & Poor's examine Sharia compliance as part of the ratings process?

No, we do not evaluate or comment upon the Sharia compliance of any Islamic financial transaction or institution. It is up to the Sharia board of the originating institution to rule on compliance of a transaction with Islamic law. We focus on assessing creditworthiness. As a part of that analysis, we also take a look at whether the transaction or institution adheres to the commercial law of its jurisdiction.

The Five Pillars Of Islamic Finance

The ban on interest

Interest must not be charged or paid on any financial transaction, as interest (or the intrinsic value of the money) is deemed unlawful by Sharia.

The ban on uncertainty or speculation

Uncertainty in contractual terms and conditions is forbidden. However, risk taking is allowed when all the terms and conditions are clear and known to all parties.

The ban on financing certain economic sectors

Financing of industries deemed unlawful by Sharia--such as weapons, pork, and gambling--is forbidden.

The profit- and loss-sharing principle

Parties to a financial transaction must share in the risks and rewards attached to it.

The asset-backing principle

Each financial transaction must refer to a tangible, identifiable underlying asset.

Vocabulary Of Islamic Finance

Bay salam

A sales contract where the price is paid in advance and the goods are delivered in the future, provided that the characteristics of the goods are fully defined and the date of delivery is fixed.

Diminishing musharaka

A form of partnership in which one of the partners undertakes to buy the equity share of the other partner gradually until ownership is completely transferred to the buying partner.

Gharar

An exchange transaction in which one or both parties remain ignorant of an essential element of the transaction.

Halal

Lawful; permitted by Sharia.

Haram

Unlawful; prohibited by Sharia.

IFI

Islamic financial institution.

Ijara

Lease financing. The purchase of the leased asset at the end of the rental period is optional.

Ijara muntahia bittamleek

A form of lease contract that offers the lessee the option to own the asset at the end of the lease period, either by purchase of the asset through a token consideration or payment of the market value, or by means of a gift contract.

Ijara wa iqtina

Lease purchasing, where the lessee is committed to buying the leased equipment at the end of or during the rental period.

Investment risk reserve

The amount appropriated by an IFI from the income of PSIA holders, after allocating the mudarib's share of the profit or mudarib fee (mudarib refers to the IFI as a manager of the PSIA), in order to create a cushion against future investment losses for account holders.

Istisna

A contract that refers to an agreement to sell to a customer a nonexistent asset, which is to be manufactured or built according to the buyer's specifications and is to be delivered on a specified date at a predetermined selling price.

Mudaraba

A contract between a capital provider and a mudarib (skilled entrepreneur or managing partner) whereby the IFI provides capital to an enterprise or activity to be managed by the mudarib. Profits generated by that enterprise or activity are shared in accordance with the terms of the mudaraba agreement while losses are borne solely by the capital provider, unless the losses are due to the mudarib's misconduct, negligence, or breach of contractual terms.

Murabaha

The financing of a sale at a determined markup (cost plus profit margin).

Musharaka

A contract between an IFI and a customer to provide capital to an enterprise, or for ownership of real estate or a moveable asset, either on a temporary or permanent basis. Profits generated by the enterprise or real estate/asset are shared in accordance with the terms of the musharaka agreement, while losses are shared in proportion to each partner's share of capital.

Profit equalization reserve

The amount appropriated by an IFI from mudaraba income before allocating the mudarib share (fee; mudarib refers to the IFI as a manager of the PSIA), in order to maintain a certain level of return on investment for PSIA holders.

PSIA (profit-sharing investment account)

A financial instrument relatively similar to time deposits of conventional banks. According to the terms and conditions of PSIAs, depositors are entitled to receive a share of a bank's profits, but also obliged to bear potential losses pertaining to their investment in the bank. PSIAs can be restricted (whereby the depositor authorizes an IFI to invest his funds based on a mudaraba or wakala, with certain restrictions as to where, how, and for what purpose these funds are to be invested); or unrestricted (whereby the depositor authorizes the IFI to invest his funds based on mudaraba or wakala contracts without laying down any restrictions).

Qard hasan
A loan granted for welfare purposes or to bridge short-term funding requirements; it could also take the form of a nonremunerated deposit account. The borrower is required to repay only the principal.

Retakaful
A form of Islamic reinsurance that operates on the takaful model.

Riba
Usury.

Sharia (or Shari'ah)
Islamic law.

Stability rating
A rating that represents Standard & Poor's current opinion about the prospective relative stability of cash flow distributable to PSIA holders.

Sukuk
Sharia-compliant financial certificates similar to bonds.

Takaful
A form of Islamic mutual insurance based on the principle of mutual assistance.

Wadia
An amount deposited whereby the depositor is guaranteed his funds in full on demand.

Wakala
An agency contract where the investment account holder (principal) appoints an IFI (agent) to carry out an investment on his behalf either for or without a fee.

Sources: Islamic Financial Services Board and Standard & Poor's.

S&P Shariah Indices

October 2007

Introduction

In 2006, Standard & Poor's introduced the S&P Shariah Indices. Shariah is Islamic canonical law, which observant Muslims adhere to in their daily lives. Shariah has certain strictures regarding finance and commercial activities permitted for Muslims. Over the last few years, the demand for Shariah-compliant financial products has increased.

Recognizing the urgent need for indices, which are a real gauge of the global equity markets and well-established standards, Standard & Poor's applied Shariah screens to three headline indices – the S&P 500, the S&P Europe 350 and the S&P Japan 500. The results are the S&P 500 Shariah, the S&P Europe 350 Shariah and the S&P Japan 500 Shariah indices. These are gauges of three major markets and, by screening out stocks that are not Shariah compliant, ideal investment vehicles for observant Muslims. In 2007, Standard & Poor's launched the S&P GCC Shariah Indices and the S&P Pan Asia Shariah Index, to cater to the demand for a benchmark Shariah product for those regions.

Shariah Screening

Standard & Poor's has contracted with Ratings Intelligence Partners (RI) to provide the Shariah screens and filter the stocks based on these screens. Ratings Intelligence Partners is a London/Kuwait-based consulting company specializing in solutions for the global Islamic investment market. Its team consists of qualified Islamic researchers who work directly with a Shariah Supervisory Board. It is continually working with regional banks to create Shariah-compliant equity products and expand investment offerings.

RI works with a Shariah Supervisory Board, which is a board of Islamic scholars serving to interpret business issues and recommend actions related to business decisions for the indices. The members are:

- Dr. Muhammad Ali Elgari – PhD in Economics from the University of California, U.S.A.
- Dr. Abdul Sattar Abu Ghuddah – PhD in Islamic Law from Al Azhar University, Cairo, Egypt.
- Dr. Nazih Hammad – PhD in Islamic Law from the University of Cairo, Egypt.
- Dr. Mohammad Amin Ali-Qattan – PhD in Islamic Banking, University of Birmingham, United Kingdom.

Highlights

- Leading equity indices screened for Shariah compliance
- All indices are liquid and investable
- Shariah compliance is as per the strictest standards observed by Middle Eastern countries
- Indices are maintained for compliance on a periodic basis

Index Family

Major S&P indices are selected for Shariah screening. The first launch was based on the S&P 500, the S&P Europe 350 and the S&P Japan 500, covering the three major regions of equity investing. Subsequently several other regions have been targeted, including the GCC, the Pan Asia large cap sector, global property markets, the Middle East & North Africa (MENA) and the Emerging markets, using the relevant Standard & Poor's underlying benchmark indices.

S&P 500. Widely regarded as the best single gauge of the U.S. equities market, this world-renowned index includes 500 leading companies in leading industries of the U.S. economy. The S&P 500 is a core component of the U.S. indices that are used as building blocks for portfolio construction.

S&P Europe 350. The S&P Europe 350 combines the benefits of representation with investability for the Europe region, spanning 17 exchanges. These distinguishing features make it a unique index designed for investors seeking broad market exposure through an index that is efficient to replicate. The S&P Europe 350 is the foundation of the European index series.

S&P Japan 500. Introduced in 2002, the S&P Japan 500 is designed to represent the Japanese investable market. Index constituents are drawn from eligible companies listed on the Tokyo, Osaka or JASDAQ exchanges. Constituents represent the large, mid and small cap components of the Japanese equity markets.

S&P Global Healthcare Shariah. Companies from the S&P 500 Shariah, the S&P Europe 350 Shariah and the S&P Japan 500 Shariah, which also belong to the GICS Healthcare Sector, combine to form the S&P Healthcare Shariah index. This index represents the largest, most liquid and most representative healthcare companies in the developed markets.

S&P GCC. The Gulf Cooperation Council (GCC) is an organization of six Arab states that share many social and economic objectives. These states are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirate (UAE). Standard & Poor's Emerging Markets Data Base (EMDB) indices were the first to focus on this region. The S&P/IFCG Saudi Arabia Index was launched in 1997, and the S&P/IFCG Oman and S&P/IFCG Bahrain Indices in 1998. Since 2006, Standard & Poor's has calculated indices for every country in the GCC. In 2007, Standard & Poor's launched the S&P/IFCI GCC Indices. The Indices include six Shariah-compliant country indices, a composite S&P/IFCI GCC Shariah Index, which excludes Saudi Arabia, and a composite S&P/IFCG GCC Shariah Index, which includes Saudi Arabia.

S&P Pan Asia. The stocks for this index are drawn from the Asian country indices in the S&P Citigroup Global Equity Index series, excluding Australia, Japan and New Zealand. Stocks for the universe must have at least US$ 1 billion in float-adjusted market capitalization. The number of stocks, for Shariah screening purposes, is limited to the top 15 from each country that exceeds the US$ 1 billion market capitalization threshold. Each month a universe of stocks conforming to these criteria selected once a year on March 31st, is screened for Shariah compliance to form this index. The countries eligible for inclusion in this index are China, Hong Kong, India, Malaysia, Philippines, Singapore, South Korea, Taiwan and Thailand.

S&P Global and World Property. The S&P/Citigroup Global Property Index represents and measures the investable universe of publicly traded property companies from developed and emerging markets. The constituents are companies engaged in a wide range of real estate related activities, such as property management, development, rental and investment. The component REIT stocks, in particular, include property trusts that invest in physical real estate assets and other pass through vehicles. The S&P/Citigroup World Property Index is a subset of the Global Property Index and includes companies from the developed markets only.

S&P Pan Arab. The S&P Pan Arab Shariah Index includes stocks from listed companies in the countries of Bahrain, Egypt, Jordan, Kuwait, Lebanon, Morocco, Oman, Qatar, Saudi Arabia, Tunisia and the United Arab Emirate (UAE). The underlying country indices are part of the S&P/IFCG emerging market indices. The component stocks of the underlying country indices are screened for Shariah compliance. The resulting compliant stocks are included in the Pan Arab Shariah Index. In addition, each of the underlying countries of the Pan Arab Shariah index is calculated as a standalone Shariah country index.

S&P/IFCI Large-MidCap Shariah. The S&P/IFCI Large-MidCap Shariah index includes stocks from Argentina, Brazil, Chile, China, the Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Malaysia, Mexico, Morocco, Peru, the Philippines, Poland, Russia, South Africa, South Korea, Taiwan, Thailand and Turkey. The universe is drawn from the S&P/IFCI Large-MidCap index, itself a subset of the S&P/IFCI Composite Index. The underlying index includes 90% of the market capitalization of the S&P/IFCI Composite Index. The stock selection is done each year on November 30th and, then, the resulting universe is screened for compliance. The index is maintained as per the rules outlined for all Shariah indices.

Representation

All underlying indices are representative of their respective countries and regions, while remaining highly liquid and investable. Each Shariah compliant index typically covers over 60% of the market capitalization of the parent index, though this can vary depending on the number of companies found to be compliant. Historical performance analysis, however, indicates that there is a high level of correlation between the underlying indices and the Shariah compliant indices.

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